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NEW YORK TAX INSIGHTS

Volume 4, Issue 7, July 2013

IN THIS ISSUE

New York's Highest Court Holds Retroactive Changes to Empire Zones Tax Credit Program Unconstitutional
Page 1

Tribunal Upholds Applicability of Sales Tax to Environmental Testing and Monitoring Services
Page 2

ALJ Holds a Partial Day is Enough for Residency Day Count
Page 3

Oxygen Cylinders Held Not Purchased for Resale
Page 4

Insights in Brief
Page 5

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NEW YORK'S HIGHEST COURT HOLDS RETROACTIVE CHANGES TO EMPIRE ZONES TAX CREDIT PROGRAM UNCONSTITUTIONAL

By Irwin M. Slomka

The Court of Appeals has held that 2009 amendments to the New York Empire Zones Tax Credit Program, which authorized the retroactive denial of tax credits, violated the taxpayer's rights under the Due Process Clause and were therefore invalid. *James Square Associates LP, et al. v. Dennis Mullen, Commissioner, N.Y.S. Dep't of Economic Development, et al.*, No. 88, NY Slip Op. 3935 (N.Y. Jun. 4, 2013). The Court affirmed several Appellate Division decisions holding that the amendments should not be applied retroactively, but did so on slightly different grounds.

Background. As discussed in the January 2012 issue of *New York Tax Insights*, the case involved the Empire Zones Program, enacted in 1986 to stimulate investment and job creation in designated "Empire Zones" within the State by providing tax credits. In order to qualify, the business had to be certified by Empire State Development and, before claiming any tax credits, the business had to receive a Certificate of Eligibility.

In April 2009, the law was amended to tighten the eligibility criteria for certification. Ch. 57, Laws of 2009. Under the amendments, EZ certifications could be revoked for businesses that did not meet the new eligibility criteria, which included curbing a practice in which new jobs were not truly created, but were simply transferred from an existing business to a related business (known as "shirt changing"). The Tax Law was amended to prohibit the carryover of EZ tax credits retroactive to tax years beginning on or after January 1, 2008, unless the business obtained an "EZ retention certificate," signifying that the new eligibility requirements were met. There was no question that the taxpayer did not meet the revised eligibility criteria under the amended statute.

Declaratory judgment actions were brought by several businesses that previously were certified to receive EZ tax credits, but whose certifications were later revoked retroactive to January 1, 2008, challenging the retroactive decertification. In one of those cases, a New York Supreme Court judge held that the retroactive decertifications were an unconstitutional taking of property. The Appellate Division, Fourth Department, affirmed, finding that retroactive application violated the taxpayers' Due Process rights, and therefore was null and void. *James Square Associates LP v. Dennis Mullen*, *et al.*, 91 A.D.3d 164 (4th Dep't 2011). In other cases, appeals were heard by the Third Department, which also held that the amendments could not be applied retroactively, but on the basis that they constituted an unlawful taking of property. *Matter of WL, LLC v. Dep't of Economic Dev.*, *et al.*, 97 A.D.3d 24 (3d Dep't 2012); *Matter of Hague Corporation v. Empire Zone Designation Board*, *et al.*, 96 A.D.3d 1144 (3d Dep't 2012). The State appealed all of the cases to the Court of Appeals as of right on the question of retroactivity.

Court of Appeals decision. The Court of Appeals has now affirmed that the 2009 amendments could not be applied retroactively. However, it concluded that the Appellate Division (actually, the Third Department, not the Fourth Department) incorrectly characterized the retroactive amendments as an unconstitutional "taking of property." According to the Court, the retroactive tax liability resulting from those amendments "cannot be characterized as so flagrant as to constitute the confiscation of property under the Takings Clause [under the Fifth Amendment]."

The Court applied the three-factor test for permissible retroactivity set forth in *Matter of Replan Dev. v. Dep't. of Hous. Preserv.,* 70 N.Y.2d 451 (1987), *appeal dismissed,* 485 U.S. 950 (1988): (1) Was the taxpayer forewarned of the legislative change so that reliance on the prior law was unreasonable? (2) Was the retroactive period excessive? and (3) Did the retroactive application serve an important public purpose? The Court found that all three factors weighed in favor of the taxpayer, but particularly the third factor, concluding that there was no valid public purpose served by retroactive application, and noting that "raising money for the State budget is not a particularly compelling justification."

Judge Smith dissented, and would have found the retroactive legislation constitutional under the three-part test in *Replan*.

Additional Insights

Given the difficulties often encountered in invalidating retroactive tax legislation on Due Process Clause grounds, the Court of Appeals decision is a welcome reminder that the Legislature does not have unbridled authority on retroactivity. The three-part *Replan* test is, in effect, a balancing of the equities. The retroactivity here was particularly egregious, since the taxpayers conducted their businesses in a particular way in specified disadvantaged areas, consistent with the statutory criteria then in effect. It remains unclear what impact, if any, this decision will have on the more common instance of retroactivity, such as retroactive tax rate increases. The Court noted that the case is distinguishable from cases where the taxpayer was unable to show that it detrimentally relied on a prior law or policy that was being retroactively changed. More than in most cases, there was no question that the taxpayers here took actions in direct reliance on the availability of the tax benefits.

TRIBUNAL UPHOLDS APPLICABILITY OF SALES TAX TO ENVIRONMENTAL TESTING AND MONITORING SERVICES

By Kara M. Kraman

The New York State Tax Appeals Tribunal has held that certain pre- and post-remediation environmental testing and monitoring services are subject to New York State and local sales tax. *Matter of Exxon Mobil Corp.*, DTA No. 823437 (N.Y.S. Tax. App. Trib., May 23, 2013). At issue was whether the services were subject to sales tax as "maintaining, servicing or repairing" real property.

The taxpayer, Exxon Mobil, owned and operated retail gas stations in New York. Under New York law, if a petroleum discharge was discovered at one of the properties, Exxon Mobil was required to comply with New York State

ROBERT MOSELEY NERO APPOINTED TO STATE TRIBUNAL

Roberta Moseley Nero has been appointed by Governor Cuomo to fill the vacant Commissioner seat on the New York State Tax Appeals Tribunal. Ms. Nero's appointment was confirmed by the State Senate on June 19, 2013. She returns to the Tribunal where she served for 12 years, first as Secretary to the Tribunal and then as an administrative law judge.

As many of you know, Roberta has been a member of the Morrison & Foerster New York SALT Group since 2001. We will miss our good friend and colleague, and wish her the best in her important new position.

continued on page 3

Department of Environmental Conservation ("DEC") rules for the investigation, cleanup and removal of the petroleum discharge at the site in question. The required process consisted of three general steps: (1) the performance of an environmental investigation to determine the adverse effects on adjacent properties, and whether remediation of the site was required; (2) remediation of the property, if required; and (3) post-remediation sampling, testing, and monitoring of the site for a period of time. In some cases, remediation was deemed not necessary after the initial investigation, and therefore no actual remediation or post-remediation monitoring ever occurred. Exxon Mobil hired environmental consultants to perform these services. In most cases, Exxon Mobil would hire the same consultant to investigate, remediate, and monitor the site post-remediation.

Exxon Mobil did not pay sales tax on charges for testing and monitoring services that were either: (i) performed as part of the investigation to determine if any remediation was necessary; or (ii) performed after remediation was completed. Exxon Mobil did not contest the imposition of sales tax on its payments for the remediation itself, including the attendant testing and monitoring. It did dispute the imposition of sales tax on the investigation and post-remediation services, arguing that those services did not alter the condition of the property, and that the testing and monitoring were separate and distinct from the actual remediation services.

Under the Tribunal's holding, the initial investigation and post-remediation services would be subject to sales tax on their own, even if done pursuant to a separate contract and separately billed to Exxon Mobil.

Tax Law § 1105(c)(5) imposes sales tax on "maintaining, servicing or repairing real property." The regulations define "maintaining, servicing or repairing" as covering "all activities that relate to keeping real property in a condition of fitness, efficiency, readiness or safety or restoring it to such condition." 20 NYCRR 527.7(a)(1). An Administrative Law Judge had determined that all of the pre- and post-remediation services were taxable. Applying the "primary function" test for taxability, the ALJ focused on "the service in its entirety" – the remediation of the property – rather than by considering each component of the service.

The Tribunal went one step further and held that all of the pre- and post-remediation services would be taxable as stand-alone services. It held that the pre- and post-remediation services would be taxable because they were necessary for the properties to be in compliance with DEC cleanup procedures, which fell under the regulatory definition of keeping property "in a condition of fitness, efficiency, readiness or safety." Even absent the DEC requirements, the Tribunal noted that a discharge of petroleum onto a property "inherently places a property into a state of disrepair and unfitness," a danger that requires investigating, testing and monitoring of the soil – services that fall within the plain meaning of "maintaining, servicing and repairing" property under the statute.

Additional Insights

Although the ALJ decided the case under the primary function test, the Tribunal appears to have reached the same conclusion based on the statutory language itself. This is potentially significant because under the Tribunal's holding, the initial investigation and post-remediation services would be subject to sales tax on their own, even if done pursuant to a separate contract and separately billed to Exxon Mobil.

ALJ HOLDS A PARTIAL DAY IS ENOUGH FOR RESIDENCY DAY COUNT

By Hollis L. Hyans

In *Matter of John and Janine Zanetti*, DTA No. 8243337 (N.Y.S. Div. of Tax App., May 23, 2013) a New York State Administrative Law Judge held that any part of a day spent in New York counts as a "day" for purposes of determining statutory residency.

The Zanettis agreed that they maintained a permanent place of abode in New York State. They also agreed they were present in New York State for 167 entire days in 2006, outside the State for 172 days, and in the State for a portion of 26 additional days, when they were arriving in or departing from New York State by private jet. On those days, they stayed at their New York residence after arriving or before departing.

Under New York law, individuals who maintain a permanent place of abode are treated as "statutory residents" for any given year, and taxed as New York residents, if they spend more than 183 days in the state in that year. Tax Law § 605(6)(1)(B). Therefore, the sole issue in dispute was whether the time spent in New York on the 26 "partial" days counted as "days" spent in New York.

The Zanettis argued that a "calendar day" consists of 24 hours, pursuant to the General Construction Law, and that since they were not in New York for a consecutive 24-hour period on any of the 26 disputed days, those days must be considered non-New York days. Alternatively, they argued that they were out of state for 334.3 hours during those 26 days, amounting to –

continued on page 4

using the 24-hour yardstick – 13.9 "days," which, when added to the agreed-upon 172 non-New York days, placed them outside the state for more than 183 days.

The ALJ rejected these arguments. He relied on the Department's regulation, which clearly provides that "any part of a calendar day constitutes a day spent within New York State" unless the presence is solely for the purpose of boarding an airplane or other conveyance and traveling through New York. 20 N.Y.C.R.R. § 105.20(c). This regulation had been upheld in *Matter of Leach v. Chu*, 150 A.D.2d 842 (3d Dep't), *appeal dismissed*, 74 N.Y.2d 839 (1989), as a reasonable interpretation of the authority granted to the Department by the statute. The Zanettis argued the regulation was contrary to Section 19 of the General Construction Law, which defines a "calendar day" as lasting from "midnight to midnight," and that, since the General Construction Law was not addressed in *Matter of Leach*, it must have been overlooked.

The ALJ rejected this contention, finding that the issue of how to treat a partial day was exactly the question considered and resolved by *Matter of Leach*. While the General Construction Law was not specifically referenced, the ALJ found that the language in that statue concerning a day being the period from "midnight to midnight" was one of the definitions that was considered by the court in *Matter of Leach*, but not found required by the residency statute. The ALJ also rejected the suggestion that the hours outside New York should be aggregated to reach a total outside the state of more than 183 days.

Finding that the Zanettis were in the State for at least a part of the disputed 26 days, the ALJ held those days counted as New York days under the regulation, and determined that the Zanettis were statutory residents of New York State.

Additional Insights

While the Zanettis' argument was, as noted by the ALJ, "creative," there is a long-standing body of New York law confirming that presence in New York for any part of a day results in that day being considered a New York day. The Zanettis also could not qualify for the regulatory exception of being in New York "solely" to board an airplane for travel outside the State, since they either left from or returned to their New York home on those travel days.

OXYGEN CYLINDERS HELD NOT PURCHASED FOR RESALE

By Hollis L. Hyans

A New York State Administrative Law Judge has held that oxygen cylinders were not purchased for resale by a company engaged in providing oxygen systems to customers, but rather were purchased for use in providing an oxygen service, and therefore were subject to New York sales and use tax when purchased. *Matter of Lincare, Inc.*, DTA No. 823971 (N.Y.S. Div. of Tax App., May 30, 2013).

Background. Lincare, Inc., provided oxygen to customers who made purchases in accordance with U.S. Department of Health and Human Services forms signed by their physicians. One way the oxygen was provided was with oxygen cylinders, which Lincare delivered full to customers, and then retrieved when empty and replaced with full cylinders. Lincare retained ownership while its customers had possession of the cylinders.

Lincare entered into written, month-to-month agreements with customers, and it billed and was reimbursed for the rental of oxygen cylinders under Medicare, Medicaid, private insurance or a private payment arrangement. Patients paid a monthly fee, which did not vary whether or not the patients used the cylinders for a whole month. The monthly fee included refilling the cylinders, and there were no separate charges for oxygen when cylinders were exchanged or refilled. If a cylinder was empty, Lincare replaced it with a full one without an additional charge above the regular monthly charge. On rare occasions, oxygen cylinders were sold to patients, and when that occurred, Lincare charged patients for oxygen separately.

Lincare did not pay sales tax when it purchased the oxygen cylinders. It depreciated the costs of the cylinders and carried that cost as part of its fixed assets. It recognized rental revenue from the fees it received for the rental of oxygen cylinders to its customers.

Dispute and decision. Under New York law, as in most states, sales of tangible personal property for resale are exempt from sales tax. Tax Law § 1101(b)(4)(i)(A). A "sale" of tangible personal property includes a "lease." Tax Law § 1101(b)(5). Therefore, if the cylinders were being rented or leased to patients, no sales tax would be due when they were purchased by Lincare.

Lincare argued that its written agreement with customers treated the form of the transaction as a rental, and that this structure was required by Medicare regulations. The Department argued, however, that rather than renting oxygen cylinders, Lincare was actually in the business of selling an oxygen service, and that the provision of the cylinders was merely "incidental" to that service.

The parties had stipulated that reimbursement for oxygen equipment by Medicare was only available on a rental basis; that Lincare did not separately charge for oxygen or for any services related to the cylinders; and that Lincare "billed and was reimbursed for its *rental* of the oxygen cylinders" (emphasis in original). Lincare also conceded that it charged a fixed, monthly fee, dictated by Medicare regulations, that included the cylinder rental and all other components.

continued on page 5

Despite the stipulation regarding reimbursement for rental of oxygen, the ALJ concluded that the patients were seeking, and Lincare was providing, "a complete oxygen service paid for with one carefully regulated fee." The ALJ also concluded that the oxygen, not the equipment or accessories, was of primary importance to the patients, in large part because adjustment of the Medicare reimbursement rate was based on the prescribed oxygen flow rate per minute, without reference to the cylinders.

The ALJ concluded that the patients were seeking, and Lincare was providing, "a complete oxygen service paid for with one carefully regulated fee."

The ALJ noted that no monthly agreements or invoices had been introduced as evidence, but only a document identified as "Terms and Conditions of Rental" that did not state it was a part of a monthly agreement, did not identify Lincare, and did not refer to oxygen or cylinders. He then distinguished *Matter of EchoStar Satellite Corp. v. Tax Appeals Tribunal*, 20 N.Y. 3d 286 (2012), in which the Court of Appeals concluded that equipment provided along with a service was rented to the customers and qualified as exempt. According to the ALJ, in that case the court was able to conduct a thorough review and analysis of the terms of the parties' agreements, which could not be done in this case because of the absence of documents specifically describing the terms of the parties' agreement. The ALJ concluded that, based on the record before him, he could not determine that, as had been established in *EchoStar*, the property – in this case, the cylinders – had been "rented" for a specific charge separate from the charge for the service.

Additional Insights

Many cases have dealt with the issue of whether containers or other equipment provided along with goods or services are being rented, and can therefore be purchased without tax as a sale for resale, or are simply being used to deliver a product or provide a service, meaning sales tax is due when the equipment is initially purchased. Here, despite the stipulation by both parties regarding "rental" of the cylinders, and the existence of a document titled "Terms and Conditions of Rental," the lack of specific documentation between the parties clearly distinguishing the service component from the provision of equipment and the absence of a separately stated fee for the cylinders proved fatal to the company's position. Although the cylinders seemed clearly to be "rented" for purposes of Medicare, the ALJ found that compliance with Medicare regulations using the term "rental" was not sufficient to prove the cylinders were rented to customers for purposes of the New York tax law.

INSIGHTS IN BRIEF

Appellate Division Affirms Denial of Investment Tax Credit Claimed by Utility

The Appellate Division, Third Department, affirming a Tax Appeals Tribunal decision, has upheld the denial of a State investment tax credit claimed by a public utility for pipes, mains and equipment. *Matter of Brooklyn Union Gas Co., et al. v. N.Y.S. Tax App. Trib.*, No. 514825, 2013 N.Y. App. Div. LEXIS 3980 (3d Dep't Jun. 6, 2013). The court held that the record supported the Tribunal's determination that the facilities were primarily used for the distribution and delivery of natural gas, and not for processing or manufacturing as required in order to claim the credit.

Charges for Litigation and Electronic Discovery Services are Not Subject to Sales Tax

A recent Advisory Opinion concludes that although monthly charges for litigation support services are information services, they are personal and individual in nature and therefore are not subject to New York State and local sales tax. *Advisory Opinion*, TSB-A-13(13)S (N.Y.S. Dep't of Taxation & Fin., May 20, 2013). While the Department of Taxation and Finance observed that the ability of a client to mark and redact documents online had some attributes of the use of software, it concluded that the primary function was the provision of an information service, not the sale of prewritten software.

Food for Breeding Dogs and Their Puppies Is Not Exempt from Sales Tax

The New York State Department of Taxation and Finance has issued an Advisory Opinion concluding that dog food purchased by a commercial dog breeder to be fed to breeding dogs and their puppies does not qualify for any exemption from sales tax. *Advisory Opinion*, TSB-A-13(14)S (N.Y.S. Dep't of Taxation & Fin., May 24, 2013). While Tax Law § 1105-B exempts "supplies" used in the production of tangible personal property for sale "by manufacturing, processing, generating, assembling, refining, mining or extracting," the breeding or raising of animals is not included in the list of enumerated activities. Another exemption, provided by Tax Law § 1115(a)(6)(A), for property used or consumed in the production of property by farming was similarly of no avail, since § 528.7(b) of the Sales and Use Tax Regulations explicitly excludes dog breeding from the definition of "farming."

Thoroughbred Racehorses Exempt from Sales Tax

The New York State Department of Taxation and Finance has explained how sales and use taxes apply to racehorses. *New York Sales Tax Bulletin*, No. TB-ST-755 (N.Y.S. Dep't of Taxation & Fin., Jun. 7, 2013). A thoroughbred or standardbred racehorse is exempt from tax if it is registered with an approved racing association, or is no more than 24 months old and

continued on page 6

is eligible to be registered, and is purchased with the intent of being entered in a race on which pari-mutuel wagering is authorized. Use tax is due on the purchase of such a horse outside the State by a New York resident and brought into the State, unless the horse is brought in to enter or prepare for races on which pari-mutuel wagering is allowed and the horse is entered into such races for no more than five days in any single calendar year. These exemptions do not apply to a quarter horse, a horse considered to be at least four years old that has never raced, or to certain horses purchased in a claiming race. Racehorses purchased predominantly for breeding purposes are also exempt from tax.