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MoFo New York Tax Insights

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Tribunal Reverses ALJ: Department's Imposition of Sales Tax on Game Hunting Charges is For the Birds

By Hollis L. Hyans

In the February 2011 issue of *New York Tax Insights*, we reported on the decision of a New York State Administrative Law Judge holding that per-bird fees paid by hunters to shoot birds at a game preserve are subject to sales tax as charges for the sale of tangible personal property. Now, the New York State Tax Appeals Tribunal has reversed, in a detailed analysis holding that the charges for releasing the birds were part of a nontaxable "admission charge," and rejecting the Department's very narrow interpretation of the term as an improper attempt to divide inseparable charges. *Matter of Frank M. Gugliotta D/B/A Parkview Lodge and Upland Game Preserve,* DTA No. 823157 (N.Y.S. Tax App. Trib., Aug. 18, 2011).

The facts in the case were undisputed: the petitioner operates the Parkview Lodge and Upland Game Preserve (the "Preserve"), and offers hunting of pheasant, chukar and quail. Before a hunt

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No Sales Tax on Birds

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begins, hunters must direct the Preserve to release a specified number of birds, and then the hunters have a set period of time to shoot the birds that were released at their request, as well as any other birds that were missed by earlier hunters, or that may have happened to fly by. Pricing is based solely on the number of birds the hunters want released, with some set minimums, and varies depending upon the type of bird. There is no guarantee that the hunter will kill all, or even any, of the birds paid for, since the birds may escape or the hunter may simply not be skillful enough, and there is no change in the charge depending upon the number of birds actually shot. Following the hunt, most hunters clean their own birds in an area provided by the Preserve, although some use a bird-cleaning service provided by the Preserve for a separate charge, or a taxidermy service also available at an extra charge. Hunters often eat their birds. No license is required to hunt game birds on the Preserve, and hunting is not limited to the regular New York State hunting seasons.

Over the years from 1965 to 1991, the Department had provided advice to other hunting preserves, stating that the provision of game birds at a charge by bird on a private shooting preserve is not subject to sales tax. However, upon audit of the Preserve, the Department concluded that the per-bird charges were taxable as sales of tangible personal property.

The ALJ Decision. The ALJ agreed with the Department, holding that the charges were for the sale of tangible personal property for use in conjunction with a participatory sporting activity. Although hunters received both game birds and the right to hunt, since the Preserve chose to charge only for the birds, the ALJ considered the charges to be sales of tangible personal property in their entirety. Even if they were deemed to include an amount allocable to the nontaxable activity of hunting, they would still be fully taxable as a single charge with both taxable and nontaxable components that are not separately broken out, leaving the entire charge subject to tax. The ALJ also rejected the argument that the birds were nontaxable "food sold for human consumption," finding that they were sold as prey under conditions where the success of the hunt was not guaranteed. However, the ALJ did set aside the penalty, finding that the Preserve reasonably relied on the prior written advice from the Department to others operating similar businesses.

THE TRIBUNAL CONSTRUED THE SERVICE OF RELEASING BIRDS AS PART OF THE ADMISSION CHARGE TO PARTICIPATE IN THE SPORT OF BIRD HUNTING, AND FOUND THAT THE RELEASE OF THE BIRDS WAS "'INSEPARABLY CONNECTED'" TO THE BUSINESS OF PROVIDING GAME BIRD HUNTS.

The Tribunal Reverses. The Tribunal began its analysis by examining the substance and circumstances of the transactions, and rejected as lacking factual support the Department's position that "'[t]he issue here is, simply, what is being sold. The answer is birds.'" Instead, the Tribunal found that hunters do *not* purchase birds; rather, they purchase game bird hunts. The Tribunal construed the service of releasing birds as part of the admission charge to participate in the sport of bird hunting, and found that the release of the birds was "'inseparably connected'" to the business of providing game bird hunts, and that it therefore qualified as a nontaxable admission charge under Tax Law § 1101(d)(2), which specifically includes "any service charge" and any charge "for the use of facilities." It noted that the Department's position defines "admission charge" too narrowly, by trying to divide up service and use charges that together form the activity to which the patron seeks admission, and rejected that narrow interpretation as unreasonable.

The Tribunal was very clear in rejecting the attempt made by the Department to separate out different components of the Preserve's fees, finding that the Department was seeking to "change and restrict the term admission fee by segregating core components that are properly included in a single fee." It found that the Department's interpretation would "nullify" the exemption provided for admission charges to sporting activities in which the patron is a participant. It differentiated the facts from cases where the provider does act as a vendor for goods and services separate from offering participation in a sporting activity, such as the rental of bowling shoes at a bowling alley, an example on which the ALJ had relied, or the rental of lockers at a skiing venue. In those cases, the taxable elements are readily severable from the nontaxable charge for participating in the sporting activity.

Here, the Preserve's charges to release birds did not guarantee the possession of those birds, or any other rights beyond the release, which was

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necessary to enable the hunt. There was no separate and independent transfer of possession, but only provision of an element necessary to participate in the sporting activity. The Tribunal found that the Department's theory would permit the disaggregation of service and use charges that only together form the activity sought by the patron, and could lead to such improper results as imposing sales tax on an admission charge to a swimming pool on the theory that it consisted of an entry fee to the property and a separate license to use the water to swim, or on per-game fees at a bowling alley by construing them as a combined charge for the rental of the lane and a separate license to use the pins for bowling.

Additional Insights. The Tribunal nowhere uses the phrase "primary function" to describe what it is looking for in characterizing the goals of patrons in paying their per-bird charges. However, the analysis in which it engages is very similar to that seen in cases that do use such or similar concepts, in which ALJs and the Tribunal have looked at the whole picture of what a customer is purchasing, rather than separate, disaggregated parts, to determine whether the transaction is subject to sales tax. For example, in *Matter of SSOV '81 Ltd.*, DTA Nos. 810966 & 810967 (N.Y.S. Tax App. Trib., Jan. 19, 1995), the Tribunal held that a business was primarily providing a dating service, so that the furnishing of member profile print-outs containing information on potential dates was not a separately taxable information service. Similarly, in *Matter of Nerac, Inc.*, DTA Nos. 822568 & 822651 (N.Y.S. Div. of Tax App., July 15, 2010), an ALJ held, albeit in a non-precedential decision, that the furnishing of written research reports was not a separate taxable information service, but rather only a component of a nontaxable consulting service, and that customers were primarily paying for solutions or advice in response to specific problems and questions, and not merely for information. Looked at in this light, the decision is another rejection of the effort sometimes made by the Department to try to assess tax by separately focusing only on small pieces of a transaction, rather than on what the customers are ultimately seeking.

Advisory Opinion Applies Market-State Sourcing to Receipts of Internet-Based Futures Exchange

By Irwin M. Slomka and Kara M. Kraman

Reflecting the increased tendency of the Department of Taxation and Finance toward market-based sourcing of business receipts under Article 9-A, the Department has issued an Advisory Opinion regarding the sourcing of receipts generated by a group of affiliated entities that operate an internet-based exchange platform for global futures and over-the-counter markets. *Alvarez & Marsal* (Advisory Opinion), TSB-A-11(8)C (N.Y.S. Dep't of Taxation & Fin., July 12, 2011). In that Advisory Opinion, the Department analyzed the receipts generated by a variety of business activities, finding that some were receipts from services properly sourced to where the services were performed, and others were "other business receipts" properly sourced to where the receipts were "earned."

Parent, a corporation headquartered outside New York State, owned and operated an internet-based exchange platform ("Exchange"), which functioned as a marketplace where member buyers and sellers of contracts involving commodities, futures, and other derivatives could execute transactions via the Internet. Parent owned, directly or indirectly, several subsidiaries, all of which were involved in some aspect of the global futures or over-the-counter markets, but only one of which was a registered securities broker-dealer. At issue in the Advisory Opinion was the proper sourcing of commissions and other fees charged by members of the affiliated group.

Since 2007, the receipts factor alone has been used to determine what portion of a taxpayer's business income is allocated to New York State under Article 9-A. New York law provides several different sourcing rules for determining which receipts are sourced to New York State and which are sourced outside of the State, depending upon the category of the receipts. For instance, receipts from the furnishing of a service are sourced to where the service is performed. Receipts that do not fall into an enumerated category are classified as "other business receipts," and are sourced to where they are "earned." A separate set of receipts factor sourcing rules, based on customer location, apply to the various types of receipts generated by a registered securities or commodities broker-dealer.

The Advisory Opinion dealt with how the various types of receipts earned by the Exchange platform provider and its affiliates should be sourced. While an analysis of the many fees discussed

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Market-State Sourcing

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in the 13-page opinion is beyond the scope of this article, the Department's analysis of several categories of receipts is instructive.

Parent, which was not a registered broker-dealer, charged a minimum fee to each member of the Exchange to access the data on the Exchange, and charged commission, transaction, and confirmation fees for each successful execution of a trade. Citing several earlier Advisory Opinions, the Department found that all of these receipts were essentially derived from the activity of a customer who accessed the Internet to obtain information from Parent, confirm a transaction, or complete a transaction, and as such, constituted "other business receipts." The Department found that under these circumstances "other business receipts" were properly sourced to the location of the customer who accesses or conducts a trade through the Exchange. Receipts earned by an affiliate that was also not a registered broker-dealer, and that operated a global futures exchange similar to Parent's, were treated by the Department in the same manner. The only difference in the treatment of the affiliate and Parent was that the Department treated commissions earned by the affiliate from "open outcry" trading on the affiliate's trading floor as fees for services, and sourced the fees to where the service was performed, in this case the location of the physical trading floor.

Another affiliate, also not a registered broker-dealer, operated an automated digital auction business for the global OTC financial markets. It earned commissions from each counterparty to an executed trade. The Department ruled that fees generated through interdealer broker-assisted trades were receipts from services, and were sourced to the location of the interdealer broker involved in the transaction. However, commissions earned by the affiliate from electronic trading were found to constitute "other business receipts," and sourced based on customer location. The Department differentiated between purely electronic trades and trades facilitated by interdealer brokers, noting that the interdealer brokers provided the services of expertise and advice to the customers.

BASED ON THE ADVISORY OPINION, RECEIPTS FROM WHOLLY ELECTRONIC TRADING ACTIVITIES AND TRANSACTIONS WILL BE VIEWED BY THE DEPARTMENT AS "OTHER BUSINESS RECEIPTS," RATHER THAN AS SERVICE FEES, AND SOURCED TO THE LOCATION OF THE CUSTOMER.

The one affiliate that was a registered broker-dealer earned revenue through trade commissions, as well as from its digital auction business in which customers paid fees to execute purchase and sale orders digitally. Applying the sourcing rules applicable to registered securities broker-dealers, the Department found that the trade commissions and digital auction fees were brokerage commissions and should be sourced to the mailing address of the customer based on the broker-dealer's records.

Additional Insights. This Advisory Opinion offers important insight into how the Department is inclined to characterize and source various types of receipts earned in the financial services industry, but that are not earned by a registered securities broker-dealer. Based on the Advisory Opinion, receipts from wholly electronic trading activities and transactions will be viewed by the Department as "other business receipts," rather than as service fees, and sourced to the location of the customer. However, where the charges are made for the involvement of interdealer broker or other real persons in facilitating the transaction, or for transactions taking place on an actual physical trading floor, the transaction is more likely to be viewed as a service and sourced to where the service is being provided. The Advisory Opinion goes further than the earlier opinions, cited as being "substantially similar," which involved the provision of access to databases and sales of gift certificates.

The receipts generated from electronic trades and related transactions technically are sourced under different rules for registered broker-dealers (considered for services and sourced based on customer mailing address) and for others (considered "other business receipts" sourced where earned). Ultimately, under the Advisory Opinion the receipts are both sourced to the same place, the location of the customer. The Advisory Opinion reflects the Department's increased tendency to classify receipts from financial services as "other business receipts," rather than as service income, and therefore as earned where the payor customer is located. This tendency is likely to continue now that Article 9-A utilizes single-factor apportionment for business income, possibly since customer-based sourcing provides the State of New York with a more predictable taxable income base.

Department of Taxation & Finance Issues Guidance to Implement the Marriage Equality Act

By Hollis L. Hyans

Effective July 24, 2011, New York State enacted the Marriage Equality Act (the "Act"), providing that all marriages, whether of same-sex or different-sex couples, will be treated equally under all New York State laws. On July 29, 2011, the New York State Department of Taxation and Finance issued initial taxpayer guidance to describe the effect of the Act on various tax laws. "The Marriage Equality Act," TSB-M-11(8)C, 11(8)I, 11(7)M, 11(1) MCTMT, 11(1)R, & 11(12)S (N.Y.S. Dep't of Taxation & Fin., July 29, 2011). The Department also announced it will be posting on its website additional guidance as it is developed.

For purposes of the New York personal income tax, same-sex married couples must file as married, even though they cannot file as married for federal tax purposes, and they must recompute their federal income tax income, deductions and credits as if they were married for federal purposes. For personal income tax purposes, the Act is effective for tax years ending on or after July 24, 2011, so for couples married as of December 31, 2011, their married filing status starts in tax year 2011. A same-sex couple legally married in another state prior to July 24, 2011, is not considered married for New York purposes until July 24, 2011, and 2011 is the first year such a couple may use the married filing status.

For purposes of withholding tax, the Department advises same-sex married employees that they may want to file a new Form IT-2104, *Employee's Withholding Allowance Certificate*, since they will be filing their New York returns using a married status. This also means that New York employers will be required to stop withholding New York tax on the value of certain benefits, such as domestic partner health care coverage, if the value of those benefits would not be included in taxable wages when provided to a different-sex spouse.

FOR PURPOSES OF THE NEW YORK PERSONAL INCOME TAX, SAME-SEX MARRIED COUPLES MUST FILE AS MARRIED, EVEN THOUGH THEY CANNOT FILE AS MARRIED FOR FEDERAL TAX PURPOSES.

For purposes of the estate tax, the New York taxable estate of a decedent in a same-sex marriage must be computed as if the decedent were married for federal estate tax purposes, and the surviving spouse is entitled to the same deductions and elections available to different-sex spouses. This means that the estate may claim a marital deduction equal to the deduction permitted under I.R.C. § 2056, as in effect on July 22, 1998, and the estate may also make a qualified terminable interest property ("Q-TIP") election. One half of the value of any qualified joint interest in property is included in the gross estate of a same-sex spouse just as would be done with a different-sex spouse. A federal *pro forma* return must be filed with the New York estate tax return within nine months of the date of death, and if a federal estate tax return was actually required, both the *pro forma* return and the actual federal return must be provided.

ALJ Requires Nonresident Partners to Allocate to New York Gain from the Sale of New York Property

By Hollis L. Hyans

In *Matter of Ronald K. and Maxine H. Linde*, DTA No. 823300 (N.Y.S. Tax App. Trib., July 21, 2011), a New York State Administrative Law Judge held that income earned by a nonresident partnership from the sale of New York property should be allocated solely to New York.

The two petitioners were partners in Strategic Hotel Capital, LLC ("Strategic") which was headquartered in and managed from Chicago, Illinois. Strategic was engaged in the purchase, renovation and management of hotel properties, aiming to sell those properties at a gain. It acquired hotels in New York City in 1998 and 1999 and renovated them. The cost of maintaining the hotels plus the depreciation deductions available were included in Strategic's operating income, and Strategic used the three-factor business allocation percentage to allocate to New York its operating income from all of its hotels.

During 2005, Strategic sold its New York hotels, as well as hotels in other

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Gain Allocated to New York

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states. Strategic apportioned the gains using a 16% business allocation percentage on its New York State partnership return, and the Lindes allocated the same portion of the gains on their personal income tax return. Strategic was completely liquidated in 2009. The Department of Taxation and Finance conducted an audit, and took the position that the entire gains should have been allocated to New York as the situs of the properties.

The Lindes argued that, under Section 132.15 of the State's regulations, Strategic properly used a three-factor formula, set forth in Section 132.15(c), to allocate all its business income. While recognizing that Section 132.16 provides that income from the rental or real property, and gain or loss from real property, must be allocated to the property's situs, the Lindes argued that applying Section 132.16 in that way would effectively remove all real property from the property percentage, and that Section 132.16 should be limited to rental properties.

The ALJ rejected the Lindes' argument. He repeated the well-known rule that the Department's interpretation of the statute is entitled to deference as long as it is not irrational, unreasonable or inconsistent with the statute, and he found the Department's interpretation wholly consistent with Tax Law §§ 631 and 632. He noted that Section 132.15(d) specifically addressed the issue, and provided that real property that produces income or gain that is allocated pursuant to Section 132.16 is disregarded in computing the property percentage, and that under Section 132.16 gains from the sale or exchange of real property — as well as income from property rental — are treated as entirely derived from the situs of the property.

The ALJ also rejected the Lindes' attempts to rely on other cases in which various items had been found to be apportionable rather than allocable. He concluded that none of those cases applied when the gain was from the sale of real estate, rather than from, for example, development and managements fees, as in *Matter of Domber v. Tax Appeals Tribunal*, 210 A.D.2d 529, 531-32 (3d Dep't 1994), *lv. denied*, 85 N.Y.2d 810 (1995), or allocation of ordinary business income as in *Matter of Ausbrooks v. Chu*, 66 N.Y.2d 281 (1985).

The ALJ also rejected the Lindes' argument that interest should be abated due to the Department's intentional delay, finding that they had neither alleged nor established any unreasonable errors or delays.

Additional Insights. The regulation relied upon by the ALJ, Section 132.16, certainly provides that gain or loss from the sale of real property, as well as income and deductions from the rental of real property, is treated as entirely derived from the situs of the property. However, the ALJ does not seem to resolve the taxpayers' argument that such a rule effectively excludes from the property percentage of Section 132.15 any property that generates income or loss, whether from rental or sale. Under the ALJ's interpretation, it appears that virtually all real property might be found to be allocable rather than apportionable. Presumably, the only property that would be included in the property factor is property that is used by the partnership but does not generate any income, loss or deductions. If a partnership rents space in New York State, and then sublets a portion of that space, thereby earning rental income, should the property (measured at eight times the gross rent) be included in or excluded from the apportionment factor? Also, the facts as recited seem to suggest that, in earlier years, the partnership used the three-factor apportionment formula to allocate to New York only a portion of the costs and depreciation deductions attributable to the properties. If that is correct, then there seems to be a mismatch between the treatment of costs and deductions in the earlier years (which were apportioned) and the treatment of gain in later years.

State Provides Guidance on MCTD Payroll Tax for "Temporary Assignment" Employees

By Irwin M. Slomka

A recent Advisory Opinion of the Department of Taxation and Finance addresses the question of when an employer must pay Metropolitan Commuter Transportation District Mobility Tax ("MCTD Tax") on compensation paid to its employees who work on temporary client assignments in various locations. *Advisory Opinion*, TSB-A-11(1)MCTMT (N.Y.S. Dep't of Taxation & Fin., July 21, 2011).

Beginning in 2009, most employers who operate within the Metropolitan Commuter Transportation District, which includes the five boroughs of New York City and seven nearby counties, are subject to the .34% MCTD Tax, a payroll tax on the employer, on the payroll of "covered employees." Covered employees are defined as employees whose services are "allocated" to the MCT district. In "Metropolitan Commuter Transportation

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Guidance on MCTD Payroll

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Mobility Tax," TSB-M-09(1)MCTMT (N.Y.S. Dep't of Taxation & Fin., June 1, 2009), the Department established a series of four alternative tests – localization, base of operations, place of direction and control, or employee residence – to determine when an employee is a "covered employee." If an employee is a "covered employee" under *TSB-M-09(1)*, all of the payroll expense for that employee is subject to the tax, without any allocation.

The question considered by the new Advisory Opinion is whether the prohibition against allocating payroll expense for an employee applies to employees on temporary assignments both within and outside of the district who do not have a "base of operations" anywhere.

The Advisory Opinion concerns a taxpayer that provides temporary staffing services to clients throughout the United States, primarily in the health care field. Most of its employees, called "billable employees," work exclusively on temporary assignments for the company's clients. These employees never report to the company's offices, but only report to their temporary work assignment, wherever the client is located. This is usually, but not always, in the employee's home state of residence.

Two situations are presented: Employee 1, a New York State resident, received temporary assignments from the company's New York State office. For the first seven months of 2009 (January through July), the employee was assigned to a client location in the MCT district. For the next five months (August through December), the employee worked at a temporary assignment at a client's Georgia location. Employee 2 is the reverse situation: a Georgia resident who receives assignments from the company's Georgia office, and who worked at a temporary assignment in Georgia between January and July, and in the MCT district from August through December.

It was clear that both Employee 1 and Employee 2 would be considered "covered employees" for at least part of the year, since they worked on temporary assignments exclusively within the district, meeting the localization test. The ultimate question was whether the prohibition against allocating payroll expense would result in all of their payroll – for work performed both within and outside of the MCT district – to be subject to the MCTD payroll tax.

Critically, the Department ruled that the prohibition against allocating payroll expense applies only to employees who work at multiple locations *over the course of one assignment*. Since here Employees 1 and 2 have two distinct, consecutive assignments, it was appropriate to determine whether the employee was a covered employee *for each separate assignment*.

For their temporary Georgia assignments, the Department found that the employees did not meet the localization, base of operations, place of control or direction, or residence tests, and thus were not covered employees for those assignments, and their payroll with respect to those assignments was not subject to the tax. Since the employees met the localization test with respect to their temporary assignments within the district, they were covered employees with respect to those assignments, and their associated payroll expense was subject to the tax.

Additional Insights. The Advisory Opinion reaches an eminently reasonable result in bifurcating the classification of employees who are not connected with a "base of operations" anywhere, and who work on distinct and consecutive temporary assignments in various locations. It should be cautioned that the prohibition against an employer allocating payroll expense still remains with respect to employees who work at multiple locations over the course of one assignment. Moreover, the Advisory Opinion involves the somewhat unusual situation where the employee has no physical base of operations anywhere. Still, in allowing employers to ascertain, on an assignment-by-assignment basis and regardless of the employee's state of residence, whether such employees are covered employees, the Department has prudently avoided subjecting to the MCTD tax compensation having no connection with the MCT district.

Insights in Brief

City Tribunal Affirms Denial of Deduction for Pension Plan Contributions

In *Matter of Murphy & O'Connell*, TAT(E)06-18(UB) (N.Y.C. Tax App. Trib., July 26, 2011), the New York City Tax Appeals Tribunal affirmed the decision of the Deputy Chief Administrative Law Judge that payments made to a pension plan for the benefit of partners in an unincorporated business are nondeductible payments to partners under Section 11-507(3) of the Administrative Code. In reliance on *Matter of Horowitz v. New York City Tax Appeals Tribunal*, 41 A.D.3d 101 (1st Dep't 2007), *lv. denied*, 859 N.Y.S.2d 395 (2008), and *Matter of Proskauer Rose, LLP v. New York City Tax Appeals Tribunal*, 57 A.D.3d 287 (1st Dep't 2008), the City Tribunal held that payments to a pension plan on behalf of partners are treated, for UBT purposes, the same as compensation paid directly to partners, and may not be deducted, whether or not the payments were included in the individual partners' federal taxable income. The City Tribunal also rejected the argument that the Department of Finance was required to promulgate a rule before applying the statute to these specific facts, finding that the Department was entitled to rely on previous court decisions as precedent when interpreting the statute.

Transfer of Stock Prior to Sale Did Not Shield Taxpayer from Tax on Gain from Sale

In *Matter of David L. Siegel*, DTA No. 823107 (N.Y.S. Div. of Tax App., Aug. 18, 2011) the taxpayer, a New York resident, disposed of all of his shares in a corporation prior to its sale, gifting roughly half of the shares to his wife, a Florida resident, and contributing the other half to a newly formed S corporation in exchange for all of the S corporation's outstanding stock. He argued that because he did not own the shares at the time of sale, he did not owe New York income tax on gain from the sale of the shares. The Administrative Law Judge found, however, that the taxpayer's transfer of shares to his wife did not have any economic effect because he did not relinquish control of the stock, and that the transfer of shares to the S corporation lacked economic substance and was carried out for tax avoidance purposes. Accordingly, the ALJ declined to recognize the transfers for tax purposes, and held that New York income tax was owed on the gain.

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