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GOVERNOR'S TAX REFORM COMMISSION ISSUES FINAL REPORT

By Irwin M. Slomka

New York Governor Cuomo's "New York State Tax Reform and Fairness Commission" has submitted its final report of recommendations for changes to the State's tax system and administration. N.Y.S. Tax Reform & Fairness Comm'n, *Final Report* (Nov. 11, 2013). The recommendations – presented as a menu of options for the Governor to consider – are thoughtful and potentially far-reaching. Most of the reform options would require legislation. If substantially enacted, the reforms would represent the most significant overhaul of the New York tax system in decades.

Background

The Commission was announced in early 2012, and the Governor appointed the ten members in late 2012, chaired by H. Carl McCall (formerly the New York State Comptroller and now chair of the State University Board of Trustees) and Peter J. Solomon (founder and chair of the investment advisory firm that bears his name). The stated goal was to conduct a comprehensive review of the State's tax policies and make "revenue-neutral" recommendations to improve the current State tax system.

The Commission's recommendations are divided into five "packages":

1. Sales Tax Reform

The Commission has concluded that the sales tax law is both outdated in its scope and regressive in its impact on New Yorkers. It proposes several sales tax "options," some of which are driven by a large broadening of the sales tax base:

- Under one option, the sales tax exemption for clothing and footwear costing less than $110 would be repealed. The resulting surplus revenues would permit what the report describes as "targeted tax relief" to low and middle income families through enhanced income tax credits or some form of real property tax relief.

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- Another option would be driven by an expansion of the sales tax base to include digital products not currently subject to New York sales tax (such as music streaming services, eBooks and video on demand services), along with the elimination of several sales tax exemptions that the Commission refers to as "outdated."

- Although not a "recommendation," the Commission suggests that the various exemptions applicable at the State level, but not in certain localities, be studied and reconsidered. The Commission acknowledges that many of these options would be controversial because they would remove exemptions that have been in place since the State sales tax was enacted in 1965. This would include, for example, subjecting to sales tax certain personal services, dry cleaning and laundry services, and Broadway arts and movie admissions.

2. Estate and Gift Tax Reform

The Commission proposes a "package of revenue neutral reforms" that includes:

- Increasing the current New York State estate tax exemption from $1 million to $3 million, to provide less of an incentive for New York residents to move to states without an estate tax.
- Reinstating the New York gift tax, which was repealed in 2000.

3. Corporate Tax Reform

The Commission concludes that New York's method for taxing corporations and banking institutions – which has not been significantly changed in more than 25 years – needs to be reformed. The Commission has used as a starting point a corporate tax reform proposal made by the Department as part of an ongoing working group initiative. With the benefits of the Department's prior work, the Commission's recommendations in this area are the most detailed, and include the following:

- Merging the bank tax (Article 32) into the corporate franchise tax (Article 9-A).
- Adopting customer sourcing rules for the single receipts factor.
- Adopting full "Water's Edge" unitary combined filing, and permitting a corporate taxpayer to make a binding 7-year election to include in its combined return all non-unitary members where a 50% ownership test is satisfied.
- Adopting economic nexus.
- Eliminating the long-standing concept of "subsidiary income" (which currently is not taxable) and limiting the scope of investment income treatment.
- Scaling back the investment tax credit for manufacturing, completely repealing the investment tax credit for the financial services industry, and allowing the Brownfield Tax Credit program to sunset in 2015.

4. Real Property Tax Administration

Focusing on improving the administration of the real property tax system outside New York City, the Commission concludes that there is a need for greater uniformity among the localities, including establishing "clear statutory assessment standards," and standards for the frequency of assessments. The Commission's recommendations in this area are the most general.

5. Tax Simplification

Finally, the Commission's report contains a laundry list of options to simplify tax compliance and improve the efficiency of State tax administration. Among its many suggestions are the following:

- Repeal of the stock transfer tax (which has been completely refundable since 1981, and has served no discernible purpose since 2008 when the New York City Municipal Assistance Corporation bonds that it secured were retired).
- Repeal of the corporate organization tax (on New York corporations) and license fee (on out-of-State corporations).
- Establish a 14-day "safe harbor" before a nonresident individual working in the State becomes subject to New York State personal income tax, other than for athletes and entertainers (there is currently a State audit policy containing 14-day safe harbor for employer withholding liability, but it does not relieve the employee from liability).
- Repeal local gross receipts taxes and school district sales taxes (but not the New York City utility tax), to be replaced with an increased State gross receipts tax, the increased revenues from which would be distributed to the localities. Alternatively, local telecommunications gross receipts taxes would be repealed, but local gross receipts taxes on energy increased.

Additional Insights

The scope of the Commission's recommendations is very extensive, and the recommendations do not lend themselves to quick analysis. It is reasonable to expect that at least some of the Commission's recommendations will make their way into the Governor's Budget Bill for FY 2014-15. Although presented as "revenue neutral," the Commission cautions that its revenue estimates are "inevitably uncertain." A New York State Tax Relief Commission, separately established by the Governor in October 2013 (and comprised of some of the same members that are on the Tax Reform Commission), will be making its own recommendations for reducing State property tax and business taxes by December 6, 2013.

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THIRD DEPARTMENT AFFIRMS TRIBUNAL: GOVERNMENT FINANCING ARRANGEMENTS ARE NOT INVESTMENT CAPITAL

By Hollis L. Hyans

Sustaining a decision of the New York State Tax Appeals Tribunal, the Appellate Division, Third Department, has held that equipment financing agreements between Xerox Corporation and various governmental entities did not qualify for treatment as "investment capital." *Xerox Corp. v. N.Y.S. Tax App. Trib.*, 973 N.Y.S.2d 458 (3d Dep't 2013). The Appellate Division agreed with the Tribunal that the finance agreements did not constitute "other securities" within the meaning of Tax Law § 208(5) and (6), accepting the Tribunal's reliance on securities law cases, and finding no evidence that the finance agreements were intended to be treated by the parties as debt instruments.

Background

Xerox entered into various types of financing agreements with governmental entities, including leases and installment sale agreements, which allowed the governmental entities to pay for equipment over a period of time, generating payments to Xerox for the equipment it provided, plus interest income. On its original New York State franchise tax returns for 1997 through 1999, Xerox treated the revenue from all the agreements as business income. It later submitted refund claims and amended returns, reclassifying the interest income from the financing agreements as income arising from investment capital. Tax Law § 208(5) defines "investment capital" as "investment in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business...." While agreeing with the Department that the financing agreements did not qualify as either stocks or bonds, Xerox argued that that they were nonethelesss "other securities."

> "[C]lassifying as securities what are essentially no more than basic sale or lease contracts…would be contrary to the statutory language and legislative intent."

Prior to December 1989, the Department's regulations limited "other securities" to instruments that, among other requirements, were "'designed as a means of investment, and issued for the purpose of financing corporate enterprises and providing a distribution of rights in, or obligations of, such enterprises' 20 NYCRR former § 3-4.2[c]." That regulation was amended effective December 7, 1989, to provide that "stocks, bonds and other securities" includes "debt instruments issued by the United States, any state, territory or possession...." 20 NYCRR § 3-3.2(c)(1) and (2).

Proceedings Below

In October 2010, an Administrative Law Judge ruled in favor of Xerox, finding that the regulatory definition of "other securities" included in investment capital clearly encompassed "debt instruments issued by [governmental entities]" 20 NYCRR § 3-3.2(c)(2), and rejecting any reliance on the former version of the regulation. In January 2012, the Tribunal reversed, focusing its analysis not on the regulation but on the statute itself, finding that, in order to qualify as "other securities," the items must first be found to be "securities." Under State securities law, the Tribunal found that, in order to qualify as "securities," assets must, in addition to being an investment of money, represent an investment in a common enterprise, with profits expected to result solely from the efforts of others. The Tribunal found that the leases and installment sale agreements did not satisfy those tests, since there was no "commonality between the investment and the return." The Tribunal also found significant the facts that there was no "expectation of profits solely from the work of others"; that the agreements were designed as product leases and sales, not to finance corporate enterprises; that they were "created in petitioner's ordinary course of business", and that the business nature of the transactions did not change merely "because the sales involved extensions of credit to customers."

Third Department Decision

The Appellate Division held that the financing agreements were not investment capital. First, the court cited the "well-established law" that it would defer to the administrative agency's interpretation of the law as long as it was not "'irrational or unreasonable.'" Under this rule of deference, the court found that the Tribunal's determination was rational, and that "classifying as securities what are essentially no more than basic sale or lease contracts...would be contrary to the statutory language and legislative intent."

The court then went on to find that the term "other securities," as used in the statue, is limited to instruments that are similar to stocks and bonds, and that it was necessary to consider "economic reality." The court found that the financing agreements were not sold in the open market or on a recognized exchange; were not designed as a means of investment; were not commonly recognized by investors as securities; and that, as the Tribunal found, they did not involve "'an investment of money in a common enterprise with profits to come...from the efforts of others.'"

The court also agreed with what it described as the Tribunal's "implicit rejection" of the ALJ's conclusion that the finance agreements are "other securities" in that they are "debt instruments" under the regulation, 20 NYCRR 3-3.2(c)(2). The court found no evidence that the agreements were intended

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to be considered as debt instruments, and that they were not "issued by" any governmental entity as required by the regulation. It found that the interpretation urged by Xerox is not supported by the statute, which "clearly limited" investment capital to "securities of a similar nature to stocks and bonds."

Additional Insights

Given the absence of citations in any of the three decisions — by the ALJ, the Tribunal, or now the court – to any precedent directly on point, it appears that the argument made by Xerox concerning the treatment of interest on government equipment leases was raised in this case for the first time, although the treatment of private debt instruments has been considered by New York City. *Matter of RCA International Development Corp.*, TAT (E) 93-32 (GC) (N.Y.C. Tax App. Trib., Dec. 20, 1996) (where the New York City Tax Appeals Tribunal held that because the company had failed to establish that the instruments in question, debt instruments issued by an affiliate of the taxpayer, were "designed as a means of investment from" its perspective, they could not be treated as investment capital).

Here, both the Tribunal and the court relied heavily on definitions of the term "securities" from sources outside the Tax Law to determine that the financing agreements simply did not fall into the same category as stocks and bonds and therefore should not be treated similarly for corporation franchise tax purposes. Both the Tribunal and the court also rejected the company's alternative argument that the financing agreements qualified as "debt instruments," with the court explicitly noting that the taxpayer had presented no policy reasons that finance agreements should qualify as debt instruments when the purchaser is a governmental entity, but not when the purchaser is a private entity.

APPELLATE DIVISION HOLDS TAXPAYER FAILED TO PROVE TIMING OF HER DOMICILE CHANGE

By Kara M. Kraman

In *Robin Ingle v. N.Y.S. Tax App. Trib.*, No. 514245, 2013 N.Y. Slip. Op. 7094 (3d Dep't, Oct. 31, 2013), the Appellate Division affirmed the decision of the New York State Tax Appeals Tribunal that a New York State resident failed to prove that she had changed her domicile to Tennessee on the date she claimed.

Robin Ingle was born and raised in Tennessee. After graduating from the University of Tennessee in the mid-1980s, she moved from Tennessee to Washington, D.C., then to Chicago, and eventually to New York City. Ms. Ingle's various jobs since college all required her to travel extensively, and thus allowed her to choose the city of her residence, so long as she had access to a nearby airport, a cell phone, and a laptop.

Ms. Ingle became a New York City resident in 2000. In April 2002, she entered into a lease for a two bedroom apartment in New York City that terminated on April 30, 2004. In February 2004, Ms. Ingle became aware that her employer was going to be acquired sometime in late April or May of 2004, and that she stood to realize a substantial gain on the sale of her employer's stock. After consulting with a law firm, Ms. Ingle decided she would change her domicile from New York City to Tennessee before the sale of her stock in order to minimize her New York tax liability.

Although there is no prohibition on changing one's domicile in order to realize a tax savings, a court may subject a person's actions to more scrutiny, as appears to have been done in this case, when a change in domicile is being undertaken for that purpose.

Ms. Ingle took various steps to establish a domicile in Tennessee. She entered into a one year lease for an apartment in Tennessee beginning on April 1, 2004. She also registered to vote in Tennessee, obtained a Tennessee driver's license, and opened a Tennessee bank account, all prior to April 30. On April 30, 2004, Ms. Ingle sold her stock and realized nearly $2 million in capital gains.

Although she entered into a lease in Tennessee beginning on April 1, 2004, Ms. Ingle also extended the lease on her New York City apartment through July 2004. She testified that the extension was necessary because of her heavy travel schedule and because her boyfriend, who lived in California, was not available to help her move. No testimony or documentary evidence was offered on how much time Ms. Ingle spent in New York versus Tennessee during the critical April–July 2004 time period. Ms. Ingle eventually vacated the New York City apartment, and terminated the City lease on July 9, 2004.

The only dispute was over whether Ms. Ingle changed her domicile prior to the stock sale on April 30, 2004, or on July 9, 2004.

A person "domiciled" in New York is considered a resident individual for New York personal income tax purposes. The classification of resident versus nonresident is significant because residents are taxed on all of their income, including gains from the sale of stock, whereas nonresidents are only taxed on their New York source income. The regulations define domicile in relevant part as follows:

> Domicile, in general, is the place which an individual intends to be such individual's permanent home – the place to which such individual intends to return whenever such individual may be absent . . . . A person can have

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> only one domicile. If such person has two or more homes, such person's domicile is the one which such person regards and used as such person's permanent home. In determining such person's intentions in this matter, the length of time customarily spent at each location is important but not necessarily conclusive.

20 NYCRR §105.20(d)

The Tax Appeals Tribunal held, and the Appellate Division has now affirmed, that Ms. Ingle did not meet her burden to establish by clear and convincing evidence her "absolute and fixed intention to abandon [her New York domicile] and acquire another" until July 9, 2004, more than two months after she sold her stock. In affirming the Tribunal decision, the Appellate Division pointed out that Ms. Ingle failed to present evidence regarding how much time she spent in New York versus Tennessee during the April through July 2004 time period. In addition, the court noted that she extended the lease on her New York apartment beyond April 30, and that her rental of the Tennessee apartment did not affect a change in her lifestyle or business interests, which did not occur until she vacated the New York apartment.

Additional Insights

Whether an individual has changed her domicile is a question of fact, that can depend on a variety of circumstances "which can differ as widely as the peculiarities of individuals." The Tribunal and the courts have looked to everything from "the range of sentiment, feeling, and permanent association" with a place, to the location of a taxpayer's business activities, to informal acts that demonstrate an individual's "general habit of life." While there is no fail-proof way to prove a change in one's domicile, the more actions a taxpayer takes, both formal and informal, that demonstrate a *bona fide* intent to change his or her domicile, the more likely it is that the change will be upheld. Although there is no prohibition on changing one's domicile in order to realize a tax savings, a court may subject a person's actions to more scrutiny, as appears to have been done in this case, when a change in domicile is being undertaken for that purpose.

ALJ REJECTS DEPARTMENT'S EFFORT TO INCREASE A FOREIGN BANK'S ALLOCATION OF INCOME TO NEW YORK STATE

By Hollis L. Hyans

In *Matter of Unicredit S.P.A.*, DTA No. 824013 (N.Y.S. Div. of Tax App., Nov. 7, 2013), a New York State Administrative Law Judge rejected the efforts of the New York State Department of Taxation and Finance to recompute a bank's New York allocation factors by application of a "scaling ratio" to reduce the amount of "eligible gross income" that can be excluded from the numerator of those factors.

Statutory Treatment of International Banking Facilities

In order to encourage banks with international banking facilities ("IBFs") to locate in New York, both New York State and New York City have enacted statutes that allow IBFs to conduct specific international banking transactions without incurring state or local tax liability on the income from those transactions. A bank may elect to calculate the amount of its income taxable in New York, and its "entire net income allocation percentage" ("ENI Allocation Percentage"), by using an IBF allocation method involving a deposits factor, a payroll factor and a receipts factor. Tax Law § 1454(b)(2)(A); 20 NYCRR § 19-2.3(b). Unicredit elected this method for 1999 and 2000, the years in issue, and in calculating its ENI Allocation Percentages it followed the statutory procedure and subtracted from its deposits used to compute the deposits factor those for which the expenses were attributable to the production of "eligible gross income of the IBF." It did not include any amounts attributable to either interbranch transactions or to "non-effectively connected" income. Similarly, in computing its payroll factor as part of its ENI Allocation Percentage, it subtracted as payroll expenses amounts attributable to the production of eligible gross income of its IBF.

On audit, the Department determined that certain items did not qualify for treatment as eligible gross income, and therefore that they had to be treated as "ineligible gross income" pursuant to 20 NYCRR § 18-3.2(i). The Department then computed a fraction, known as the "scaling ratio" and described in 20 NYCRR § 18-3.9(b), to reduce the amount of deposits and wages excluded from Unicredit's allocation factors.

Proceedings at the Hearing

Unicredit argued that its IBF had only "eligible" gross income, and no "ineligible gross income" as defined by the statute or regulations, so that no scaling ratio should be applied. Unicredit also presented, over the Department's objection, an expert witness on the taxation of foreign banking corporations and the tax treatment of IBFs under New York law. The expert while testifying that Unicredit's approach to computing its factors was "reasonable," said that a "more accurate methodology" for calculating the deposits factor would have been to determine the amount of IBF deposits that would be deemed to produce deductible interest expenses attributable to "effectively connected" income. The expert's method resulted in no change to the factor as reported for 2000, and an increase in tax liability for 1999, which Unicredit conceded was correct.

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The ALJ's Decision

The ALJ held that the Department incorrectly determined that Unicredit had "ineligible gross income." Because Unicredit elected to apply the formula allocation method of 20 NYCRR § 19-2.3(b), it was only required to allocate income to New York using sections 19-2 and 19-3 of the regulation, and the definition of ineligible gross income relied upon by the Department was contained in section 18-3.2. The ALJ rejected the Department's argument that the definition in section 18-3.2 is incorporated by reference in section 19-2.3(b), noting that the regulation is "clear and unambiguous" on this point. He also found that accepting the Department's interpretation would require disregarding specific language in the statute and in the regulations requiring that transactions between the IBF and its foreign branches not be considered and that the interpretation urged by the Department was in conflict with both the Department's guidance that "'[f]or purposes of computing the allocation percentages, in no event shall transactions between the taxpayer's IBF and its foreign branches be considered,'" as set forth in TSB-M-85(16)C (N.Y.S. Dep't of Taxation & Fin., Feb. 10, 1986), and with the Department's Audit Guidelines.

[The ALJ] found that accepting the Department's interpretation would require disregarding specific language in the statute and in the regulations requiring that transactions between the IBF and its foreign branches not be considered.

Finally, the ALJ was persuaded by Unicredit's argument that the starting point for computing entire net income under Tax Law § 1453(a) is federal taxable income under Internal Revenue Code § 882, and that income or expenses from interbranch transactions are not included in the computation of federal taxable income or New York entire net income for 1999 or 2000. Therefore, ineligible gross income of the IBF cannot include interbranch income or expenses or non-effectively connected income, since both "were, in fact, not income at all for purposes of New York State's entire net income or formula allocation method."

Additional Insights

While in general the Division of Tax Appeals will defer to the Department's interpretation of statutes and regulations, here the ALJ undertook a careful analysis of the statute and regulations, as well as the relevant provisions of the Internal Revenue Code, and concluded that the interpretation urged by the Department was in conflict with not only the statutory and regulatory provisions but the Department's own guidance.

The ALJ also rejected the Department's argument that the testimony of Unicredit's expert should be given little or no weight because the expert had a personal interest – since several of his clients would benefit from a determination in favor of Unicredit – and because he was unfamiliar with the United States Supreme Court's decision in *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) (in which the United States Supreme Court upheld Iowa's single-factor sales formula as constitutionally sufficient under the circumstances presented). The ALJ noted that there was no evidence the expert witness had a personal stake in the outcome, and in fact his testimony corrected the returns that were filed, resulting in an increased tax in one year. The ALJ also concluded that reliance by the Department on the expert's unfamiliarity with *Moorman* was "misplaced," since the issue before the Division of Tax Appeals was simply whether the Department correctly applied formula allocation rules set forth in New York's statute and regulations – an issue not addressed in *Moorman*, which dealt instead with the constitutional sufficiency of a state's chosen formula.

The Department, in arguing for its revised allocation percentages, had argued that the apportionment factors need not be "correct or even accurate," since the Supreme Court has held that a rough approximation of a company's taxable income earned within the state is constitutionally sufficient. The ALJ rejected this argument as well, holding that it "misses the central issue in the case," since Unicredit was not challenging the apportionment scheme on a constitutional basis, but simply was seeking to apply the statutory and regulatory methods as actually written.

INSIGHTS IN BRIEF

ALJ Disallows Taxpayer's Demand for Particulars Regarding Department's Pleadings

An Administrative Law Judge has issued an Order rejecting a taxpayer's Demand for a Bill of Particulars seeking information and the identification of documents supporting the Department's Answer in a personal income tax case. Under the Rules of Practice and Procedure before the Tax Appeals Tribunal, a party may serve a demand for a Bill of Particulars to seek further details regarding allegations in a pleading in order to prevent surprise at the hearing and limit the scope of proof. The ALJ ruled that the taxpayer's detailed demand was overbroad and constituted "an improper effort at discovery." Given the substantial number of improper requests, the ALJ vacated the entire demand, declining to "prune" the demands to identify those that may have been proper. *Matter of Patrick Murphy, et al.*, DTA No. 825277 (N.Y.S. Div. of Tax App., Nov. 7, 2013).

Tribunal Upholds Denial of Innocent Spouse Relief

A previous ruling denying a wife's request for innocent spouse relief relating to final income tax assessments resulting from disallowed business expenses and itemized deductions principally relating to her husband's law practice has now been upheld by

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the Tax Appeals Tribunal. *Matter of Carnesi*, DTA No. 823507 (N.Y.S. Tax App. Trib., Nov. 7, 2013). As discussed in the January 2013 issue of *New York Tax Insights*, an Administrative Law Judge had rejected the wife's claim for relief, finding that the disallowed deductions were not "grossly erroneous items" attributable to her husband – one of the conditions for innocent spouse relief. The Tribunal upheld the ALJ's conclusion, and went further, noting that such relief was also appropriately denied because the wife "deliberately distanced herself from any and all aspects of the couple's tax filings."

Third Department Confirms Tribunal on Payment of Interest

In *Michael A. Goldstein A No. 1 Trust v. Tax Appeals Tribunal*, 2013 N.Y. Slip. Op No. 7220 (3rd Dep't, Nov. 7, 2013), the Appellate Division, Third Department, affirmed the decision of the Tax Appeals Tribunal that a statutory amendment that allows interest to be paid on a refund from the due date of the original return, rather than only from the date of the amended return, cannot be applied retroactively. The court found no merit in the taxpayers' assertion that, because the amended returns in this case arose from federal changes, the former version of the statute did not apply.

Department Issues Advisory Opinion Requiring Out-of-State Wine Seller to Collect New York Sales Tax

In an *Advisory Opinion*, TSB-A-13(35)S (N.Y.S. Dep't of Taxation & Fin., Oct. 16, 2013), the Department determined that a California retailer of bottled wine must collect sales tax on sales of bottled wine to New York State residents, even though it has no employees or agents of any kind in New York and no place of business or property in the State. The Department found that the New York statute, Alcoholic Beverage Control Law § 79-c[3][f], which conditions permission to sell out-of-state wine in New York on the seller collecting sales tax and consenting to jurisdiction in New York State, was constitutional, regardless of whether the seller had a physical presence in New York. The Department's Advisory Opinion relied on language in *Granholm v. Heald*, 544 U.S. 460, 491 (2005), which struck down New York's former ban on direct sales of wine by out-of-state distributors, but which also noted that New York "'could protect itself against lost tax revenue by requiring a permit as a condition of direct shipping.'"

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ABB v. Missouri
Albany International Corp. v. Wisconsin
Allied-Signal, Inc. v. New Jersey
AE Outfitters Retail v. Indiana
American Power Conversion Corp. v. Rhode Island
Citicorp v. California
Citicorp v. Maryland
Clorox v. New Jersey
Colgate Palmolive Co. v. California
Consolidated Freightways v. California
Container Corp. v. California
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Current, Inc. v. California
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