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MoFo New York Tax Insights

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Taxpayer May Subpoena State's E-mails Interpreting Tax Law

By Kara M. Kraman

A New York State Administrative Law Judge has issued an order rejecting a motion by the Department of Taxation and Finance seeking to modify or withdraw a *subpoena duces tecum* issued for the production of certain departmental e-mails. *Matter of Glenna Michaels*, DTA No. 823370 (N.Y.S. Div. of Tax App., June 23, 2011). As a result, the Department must turn over to the taxpayer various intradepartmental e-mails.

The substantive case involved the issue of when gain from the sale of real property accrues to an individual who becomes a resident of New York State prior to disposing of the real property. The outcome of the case hinged in part upon the application of the so-called "accrual rule."

The taxpayer claimed that the Department had inconsistently applied the accrual rule, and therefore did not provide a rational basis for its tax assessment. To support her argument, the taxpayer had the Division of Tax Appeals issue a *subpoena duces tecum* seeking all of the Department's e-mails from senior management, including all personnel in the Offices of Counsel

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Subpoenaed E-Mails

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and Tax Policy Analysis, concerning the application or interpretation of the accrual rule.

The Department filed a motion to withdraw or modify the taxpayer's subpoena on the grounds that the e-mails are not relevant, and that the information sought is covered by the secrecy provisions of the Tax Law or is otherwise privileged as attorney-client communications. The Department also claimed that production of the voluminous e-mails — 165 in total, of approximately 1,000 pages — would be unduly burdensome.

The ALJ addressed each objection in turn. First, regarding the relevance of the documents requested, the ALJ found that the proper standard to be applied to a motion to modify or withdraw a *subpoena duces tecum* was whether the requested information is "'utterly irrelevant to any proper inquiry.'" The ALJ concluded that, based on the record, the request was not "utterly irrelevant." Second, regarding the issue of privilege, the ALJ found that the Division could produce the e-mails using discretion with regard to sensitive taxpayer information and privileged communications. Finally, the ALJ was not convinced that producing 165 e-mails was unduly burdensome, stating that "a review of 165 e-mails does not facially appear to be beyond the capabilities of the Division of Taxation." Accordingly, the ALJ ordered the Department to produce the e-mails, using its discretion with regard to sensitive taxpayer information or privileged communications, which it could either redact or omit, with an explanation of each omission.

The ALJ did emphasize that his Order did not ensure the admission into evidence of the documents produced. The ALJ explained that a subpoena merely directs the party to make the subpoenaed documents available to the court so that the court may decide on the appropriate use of such documents. He noted that should the case proceed to hearing, he would need to rule on the admissibility of the documents.

THE ALJ FOUND THAT THE PROPER STANDARD TO BE APPLIED TO A MOTION TO MODIFY OR WITHDRAW A *SUBPOENA DUCES TECUM* WAS WHETHER THE REQUESTED INFORMATION IS "'UTTERLY IRRELEVANT TO ANY PROPER INQUIRY.'"

Additional Insights. The ability of a taxpayer to subpoena not just documents directly connected with its own audit file but also the general internal e-mails of the Department may level the playing field somewhat by revealing more information regarding the Department's thought process in setting its policies. While usually it is the taxpayer that must comply with potentially burdensome document production requests, the ALJ's ruling is a reminder that a taxpayer has the ability to request the production of documents from the Department, even when their production may be somewhat burdensome, as long as they are not "utterly irrelevant."

While certain of the e-mails may still be protected from disclosure (for example, to the extent they represent advice from counsel), it is likely that there are fewer impediments to disclosure under the ALJ's Order than there would be under the Freedom of Information Law. The ALJ's Order is appealable to the Tax Appeals Tribunal.

Tribunal Finds Sufficient Business Purpose and Allows QEZE Credit

By Hollis L. Hyans

Denying an exception filed by the Department of Taxation and Finance, the New York State Tax Appeals Tribunal has upheld a claim for refund of qualified empire zone enterprise ("QEZE") credits for real property taxes, finding that the company had a valid business purpose for its reorganization, consistent with the legislative intent in allowing such credits. *Matter of Graphite Metallizing Holdings, Inc.*, DTA No. 822416 (N.Y.S. Tax App. Trib., July 7, 2011).

Facts. Back in 1998, a predecessor entity, Graphite Metallizing Corporation ("GMC 1"), received advice from its outside accounting firm that it should reorganize, in order to facilitate acquisitions and to help limit potential liabilities both for injuries resulting from its manufacturing process and for environmental issues arising from its use of a landfill. A holding company structure was recommended, in which the financial problems of one entity would not affect the others. At a stockholders' meeting in June 1998, a resolution was approved authorizing the restructuring. No mention of tax credits or the QEZE program was made in the advice or in the minutes of the

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QEZE Credits Allowed

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meeting authorizing the restructuring. Similar records of meetings held later in 1998, 1999, and 2000 also contained discussions of potential legal issues arising from GMC 1's use of a landfill, and discussions of future acquisitions. In 1999, GMC 1 actually purchased a company located in Ohio, and in 2000 it attempted to purchase another target company but was outbid by a competitor.

In July 2002, GMC 1 did reorganize, pursuant to the 1998 authorization, and began operating as a holding company, eventually changing its name to Graphite Metallizing Holdings, Inc. ("GMH 1"), the petitioner in this case. The reorganization also resulted in the creation of a new subsidiary, which eventually changed its name to General Metallizing Corporation ("GMC 2"); GMC 2 conducted GMC 1's former business activities, using the same assets, location, and workforce.

Meanwhile, during 2001 and 2002, GMH 1 (formerly GMC 1) also sought advice in connection with participating in the Empire Zone Program Act and obtaining Empire Zone Credits, and was advised to form new entities to operate in the Zone. At board meetings in 2002, participation in the Empire Zone benefits program was identified as a way to encourage the continuation of the company's operations in Yonkers, rather than seeking alternative sites in other locations, including Ohio, where its subsidiary was already operating. Documents also discussed the need to obtain QEZE certifications before the "restrictions associated with the definition of a *new business*" took effect in 2002. (Emphasis in original.) Application was made for inclusion in the Empire Zone, and in December 2002, GMC 2 was notified it was certified eligible to received benefits, retroactive to July 31, 2002. During the 2001-2002 period, the outside advisors who were consulted did not discuss environmental concerns or protection from liabilities as purposes for the restructuring, and presented documents to the company related to a "QEZE Tax Credit Restructuring Planning Strategy."

THE TAX APPEALS TRIBUNAL UPHELD THE ALJ'S DECISION, FINDING THAT AN ANALYSIS OF THE "SUBJECTIVE INTENT" OF THE TAXPAYER DEMONSTRATED THE EXISTENCE OF PURPOSES OTHER THAN THE QEZE SAVINGS.

GMH 1 applied for real property tax credits pursuant to its certification. The credits were allowed for 2003 and 2004, but denied for 2005, due to changes in the QEZE statute, which, for years beginning on or after January 2005, required demonstration of a business purpose for restructuring when a newly created business was operating the same business previously operated by an affiliate.

The business purpose requirement. As discussed in the February 2011 issue of *New York Tax Insights*, QEZE tax credits and exemptions are linked to job creation, and the level of benefits is, in very general terms, determined by a comparison of the number of jobs in a base period to the number of jobs in a particular subsequent period. To obtain greater benefits, a business would have had to either increase its employment level to twice its base year employment level, or qualify as a "new business" so that, with a base period employment level of zero, the addition of even one job would result in its entitlement to 100% of the available benefits. The possibility of an existing business simply forming a new entity and continuing the same business — referred to as "shirt changing" — had been identified as a potential problem under the old law, and the statute was amended in 2002 to provide that a corporation or partnership will not be treated as a new business if it was similar in operation and ownership to an existing entity and was not formed for a valid business purpose as defined in the statute. Tax Law former § 14(j)(4)(B). A valid business purpose must "alone or in combination constitute the primary motivation for some business activity . . . which . . . changes in a meaningful way, apart from tax effects, the economic position of the taxpayer." Tax Law § 208(9)(o)(1)(D).

The business purpose requirement for QEZE benefits was enacted on May 22, 2002, and was made applicable to entities created on or after August 1, 2002. The change resulted in a significant increase in the number of businesses being set up between May 22 and August 1, and therefore the legislature added an additional requirement that successor businesses first certified as eligible to receive QEZE benefits prior to August 1, 2002, had to meet the business purpose test to retain those benefits for tax periods beginning on or after January 1, 2005.

The ALJ Determination. After an audit, the Department denied the use of the QEZE credits for 2005, and the company petitioned for review. At the hearing, the Department contended that GMH 1 had failed to demonstrate a business purpose for the restructuring, relying heavily on the documents created during the 2001-

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QEZE Credits Allowed

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2002 period, all referencing the ability to obtain QEZE credits through the creation of a new entity.

The Administrative Law Judge found that, while at the exact time of the restructuring the primary motivation may have been to obtain QEZE benefits, that was not the sole motivation, and that other purposes existed, including the facilitation of acquisitions of other companies, increasing sales volume and market share, and isolating business risks and potential liability.

The Department filed an exception, claiming that the ALJ had misinterpreted the business purpose test and had also erred in considering evidence of both activities prior to the July 31, 2002 restructuring, and those occurring after that decision. The Department also challenged the credibility of the taxpayer's witnesses.

The Tribunal Agrees. The Tax Appeals Tribunal upheld the ALJ's decision, finding that an analysis of the "subjective intent" of the taxpayer demonstrated the existence of purposes other than the QEZE savings, although that was clearly among the purposes. The Tribunal found that the particular business purpose analysis under the QEZE statute required that the primary motivation not be the tax benefits, and that the restructuring be consistent with the statutory intent to achieve economic revitalization through private investment and job creation. Relying on the evidence from 1998 through 2000, referencing the need to limit liabilities and facilitate acquisitions, the Tribunal concluded that GMH 1 had made the decision to reorganize prior to becoming aware of the QEZE tax benefits, and that meaningful economic change occurred, since in fact the business, which had been struggling, actually did become profitable. The Tribunal also found that the reorganization was consistent with the legislative intent of the Empire Zone program, since the new structure provided the company with an incentive to stay in Yonkers, and all it needed to do was what it had previously resolved to do for other reasons.

Finally, the Tribunal rejected the Department's argument that the ALJ should not have considered evidence from periods prior to or after the actual restructuring. While contemporaneous documentation may bear "greater relevance than after-the-fact rationalizations," the Tribunal found no support for the exclusion of evidence regarding the initial business decision, the subsequent deliberation, or the eventual activities that demonstrated successful execution of the plan.

Additional Insights. In this decision, the Tribunal provides important clarification of the breadth of the "business purpose" requirement in the QEZE statute, and guidance on what sort of evidence will be regarded as useful in establishing that purpose. Unlike the decision in *Matter of Dunk & Bright Furniture Co.,* DTA Nos. 823026 & 822710 (N.Y.S. Div. of Tax App., Dec. 30, 2010), *exception filed*, in which an ALJ found the company had failed to demonstrate a business purpose unrelated to QEZE savings, here both the ALJ and the Tribunal found ample evidence of business purposes in addition to the savings available under the QEZE program. In *Dunk & Bright*, the ALJ noted that none of the non-tax business purposes offered as claimed motivations during the course of the tax proceeding had been previously documented, pursued, or implemented, and therefore he did not find persuasive the taxpayer's claim that those were true purposes. Here, the clear documentation of the other business purposes at the time the restructuring decision was made was crucial, even though there was evidence that, later on, QEZE savings were also taken into consideration.

The argument made by the Department that the Tribunal should disregard evidence of the initial motivation and the later effectuation of the plan seems quite curious and, as the Tribunal noted, unsupported by case law. In fact, in the *Dunk & Bright* case, it appears it was the Department that made arguments based on the taxpayer's having failed to take any of the steps purportedly available under the new business structure, and the ALJ relied, at least in part, on the absence of subsequent activities, noting that it was "difficult to accept the premise that any meaningful economic or other changes . . . resulted from the reorganization, given that none of the envisioned steps or activities available under the [new] business structure . . . were ever undertaken or carried out."

The Tribunal also rejected the Department's argument that the testimony of the witnesses should be deemed "irrelevant" because they were employed by GMC 2. This must come as a relief to many taxpayers challenging tax assessments, who would be left without much useful evidence if testimony of witnesses were to be regarded as "irrelevant" simply because those witnesses are employed by the taxpayer or its affiliates. It is hard to imagine how any tax case could proceed to trial under those circumstances.

Tribunal Holds Interest Payable Only from Date of Amended Returns

By Hollis L. Hyans

In *Matter of Michael A. Goldstein A No. 1 Trust*, DTA Nos. 822579, 822666 & 822681 (N.Y.S. Tax App. Trib., June 29, 2011), the New York State Tax Appeals Tribunal refused to apply retroactively a statutory amendment that would have allowed interest to be paid on a refund from the due date of the original return, holding that, during the years in issue, interest was payable only from the date of the amended return.

The sole issue in this group of three related cases was whether the taxpaying trusts, which filed claims for and received refunds of tax and partial interest based on federal changes, were also entitled to receive additional interest for the period from the date of filing of the original returns for the years in issue. The trusts argued that, as a result of the federal changes reducing the taxable income of the trusts, the taxable income of the trusts' beneficiaries *increased*. These beneficiaries were required to *pay* interest from the dates of the filing of their original returns. Therefore, the trusts argued that an inequity results if the trusts do not similarly *receive* interest from the dates of their original returns.

The Administrative Law Judge had rejected the trusts' arguments, and the Tribunal has now affirmed. It noted that, since the years in issue were prior to 1999, they were governed by an older version of the statute, under which interest was allowed only from the date of the amended return. The statute was amended to allow interest to be paid from the due date of the original return, but that amendment was made only prospectively for tax years beginning January 1, 1999. While noting the trusts' claims that the result was inequitable or unjust, and finding that the legislature apparently agreed, since the statute had since been amended, the Tribunal stated that the legislature did so only prospectively, leaving the Tribunal without authority to award interest for the period in question. The Tribunal also rejected arguments based on alleged violation of the U.S. and New York State Constitutions.

SINCE THE YEARS IN ISSUE WERE PRIOR TO 1999, THEY WERE GOVERNED BY AN OLDER VERSION OF THE STATUTE, UNDER WHICH INTEREST WAS ALLOWED ONLY FROM THE DATE OF THE AMENDED RETURN.

Additional Insights. In the face of a clear statutory provision governing the payment of interest, it is not surprising that the Tribunal failed to grant relief. This is far from the only situation in which apparent inequities existed — and continue to exist — since state tax statutes often mandate payment of interest by taxpayers for periods in which no interest is paid *to* taxpayers, and even more commonly pay interest to taxpayers at a rate far smaller than the one imposed for underpayment.

It is worth noting that the rule discussed in this case is different from the rule that applies to amended corporation franchise tax returns, where interest starts to run only from the date an amended return is filed.

Production Qualifies as "Dramatic or Musical Arts Performance" for Sales Tax Purposes

By Irwin M. Slomka

The Department of Taxation and Finance has issued an Advisory Opinion finding that a live family-oriented production constituted a "live dramatic or musical arts performance" for sales tax purposes, but declined to rule on whether tangible personal property qualified as exempt property when used directly in the production and staging of those performances. *Advisory Opinion*, TSB-A-11(18)S (N.Y.S. Dep't of Taxation & Fin., May 23, 2011).

Tangible personal property used or consumed directly and predominantly in the production of a live dramatic or musical arts performance, in a theater or similar place of assembly, is exempt from New York State (and City) sales tax. Tax Law § 1115(x)(1). Among the conditions for exemption are that the production must run for at least five performances per week for a period of at least two consecutive weeks, with no change in content, and there must be an admission charge for the performance.

Between 2007 and 2010, the taxpayer produced and presented a live show at Madison Square Garden's 5,600-seat WaMu Theatre in New York City. The performance was a winter-themed family production built around a child's journey in search of snow. It included 16 musical numbers and a host of live and puppet characters. Although

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"Dramatic or Musical Arts" Production

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some of the scenes featured juggling and acrobatics, which are often found in traditional circus performances, in nearly every case they were woven into the musical choreography and story line.

The Department first addressed whether the performance itself qualified as a "dramatic or musical arts performance." The taxpayer's previous productions had been found to be predominantly "circuses," such as in *Advisory Opinion*, TSB-A-98(1)S, (N.Y.S. Dep't of Taxation & Fin., Jan. 30, 1998), which would not qualify under the dramatic or musical arts performance exemption. The Department concluded that the production in question was significantly different than the earlier circus-type productions, and qualified as a live musical arts performance. The Department found that the acrobatic and gymnastics elements were not inconsistent with this conclusion since they furthered the continuing story line and choreography of the production.

However, the Department declined to rule on whether the tangible personal property, or services rendered with respect to that property, actually qualified for the exemption. The Department did not have sufficient facts regarding the specific property and how that property was used, or what services were being rendered with respect to that property.

Additional Insights. The Department's conclusion that the performance qualified as a dramatic or musical arts performance seems correct, and the described performances certainly are different from such non-qualifying productions as ice shows, aquatic shows, and circuses, notwithstanding that there were certain circus-like elements to the performances.

It is not surprising that the Department declined to rule on whether the specific property qualified for exemption, since that is an inherently factual determination that Advisory Opinions typically do not address. It appears from the facts that the Advisory Opinion may have been requested in connection with an ongoing sales tax audit — the Advisory Opinion describes performances that have already taken place — and in that case a determination regarding the taxability of specific property would presumably be addressed on audit.

The Advisory Opinion did not address the taxability of admission charges for the performances. Presumably that is because admission charges not only to dramatic and musical arts performances, but also to circus performances, are exempt from sales tax, so the admission charges would have clearly been exempt even if the production was found to be a "circus."

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Commissioner Jenkins Retires from Tribunal

Effective June 30, 2011, Commissioner Carroll H. Jenkins retired from the New York State Tax Appeals Tribunal. Commissioner Jenkins had been a member of the Tribunal since 1997. Before that, he served as an Administrative Law Judge with the Division of Tax Appeals and as an attorney with the Department's Office of Counsel. The Tribunal is currently operating with only two Commissioners. Several candidates are reportedly being considered to fill the position.

Leaf Collection Bags Subject to Sales Tax, Municipally Mandated Garbage Bags Are Not

The Department has issued a ruling that while a grocer's sales of municipally-mandated garbage bags are not subject to tax, sales of bags that are merely endorsed by the town are subject to tax. *Advisory Opinion,* TSB-A-11(19)S (N.Y.S. Dep't. of Taxation & Fin., June 24, 2011). Tax Law § 1116(a)(1) provides an exemption from sales tax to the "State of New York, or any of its . . . political subdivisions . . . where it is the vendor of services or property of a kind not ordinarily sold by private persons." The Department found that the municipally-mandated garbage bags, which bore the town's name and logo, were products of a kind "'not ordinarily sold by private persons,'" and therefore exempt from tax, but that the town-endorsed leaf disposal bags were not exempt because the town permitted the use of any similar bag.

Potential Disruption of Mail Service Prevents Dismissal for Untimely Petition

In *Matter of Lassana Jabateh*, DTA No. 824176 (N.Y.S. Div. of Tax App., July 7, 2011), the Department sought to dismiss a petition for hearing on the grounds that it was untimely, since it had been filed 118 days after a conciliation order was issued, outside the required 90-day period. While the Department was able to prove that the conciliation order was properly delivered to the post office for delivery by certified mail, was returned as unclaimed, and re-mailed by ordinary mail, the taxpayer established that a fire had occurred in his apartment shortly before the original mailing date and that the Red Cross had requested disaster-related relief. Thus, a question of fact was raised concerning whether, and when, the taxpayer had been unable to receive mail at his

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apartment as a result of the fire. The Department's motion to dismiss was denied and the action was allowed to proceed, although the Administrative Law Judge noted that the question could be considered again later in the proceeding on a full record if the Department again raised the timeliness issue.

Procedure Specified for Store Loyalty Cards

The sales tax treatment of discounts available through store loyalty cards depends, like the treatment of coupons, on whether the discount offered to the customer reflects a manufacturer's discount — where the full price before discount is subject to tax — or a store discount, where tax is applied only to the lower, discounted price. In "Tax Department Policy on Manufacturer's Discounts Received Using Store Loyalty Cards," TSB-M-11(10)S (N.Y.S. Dep't of Taxation & Fin., June 29, 2011), the Department sets out the procedure a vendor must follow to disclose the existence of a manufacturer's discount through a loyalty card, including providing clear notification on coupons, circulars, or advertisements; using distinguishable shelf tags; or giving a receipt, and posting a sign, clearly indicating manufacturer's discount, and using similar procedures for online sales. These notice provisions are important to follow. If a vendor fails to make adequate disclosure of the manufacturer's discount, the vendor may only *collect* tax from the customer on the lower, discounted price, but must *remit* tax on the *full sales price*, thereby becoming the payor, not merely the collector, of sales tax on the discounted amount.

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Philip Tatarowicz is a highly respected tax lawyer with over 32 years of experience advising major companies on tax-related matters. He was most recently with Ernst & Young, where he established that Big Four firm's State and Local Tax group. He has deep experience providing tax advice to many of the world's largest corporations across multiple industry groups, including industrial products, retail, consumer goods, aerospace, health care, entertainment, and utilities. He has handled every major aspect of corporate state and local tax matters, with a primary focus on corporate income, property, payroll, sales and use, gross receipts, and other transaction-based taxes. Mr. Tatarowicz earned his LL.M. in Tax from the Georgetown University Law Center, his J.D. from Northern Illinois University College of Law, and his B.A. from Benedictine University.

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Toys "R" Us-NYTEX, Inc. v. New York
Union Carbide Corp. v. North Carolina
United States Tobacco v. California
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W.R. Grace & Co.—Conn. v. Massachusetts
W.R. Grace & Co. v. Michigan
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