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MoFo
New York Tax Insights

Gain on Sale of New York Property Allocated Entirely to New York

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By Hollis L. Hyans

In *Matter of Ronald K. and Maxine H. Linde*, DTA No. 823300 (N.Y.S. Tax App. Trib., May 24, 2012), the New York State Tax Appeals Tribunal substantially affirmed the decision of an Administrative Law Judge that income earned by a nonresident partnership from the sale of New York real property should be allocated entirely to New York.

The two individual petitioners were residents of Arizona, and were partners in Strategic Hotel Capital, LLC ("Strategic"), which was headquartered in and managed from Chicago, Illinois. Strategic purchased, renovated and managed hotel properties, aiming to sell the properties at a gain. It acquired two 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 formula in its New York State partnership return to allocate to New York its operating income from all of its hotels.

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Gain on NY Property Allocable to New York

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During 2005, Strategic sold its two New York hotels, as well as hotels in other states. Strategic apportioned the resulting gains to New York on its New York State partnership return using a business allocation percentage of approximately 16%, and the Lindes allocated the same portion of the gains on their New York nonresident personal income tax return. The Department of Taxation and Finance conducted an audit, and took the position that the entire gains on the New York hotels should have been allocated to New York as the situs of the properties.

The Lindes argued that, under Section 132.15 of the Department'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 of 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 found that the Department's regulation interpreting the statute was neither irrational nor unreasonable, was consistent with Tax Law §§ 631 and 632, and was therefore entitled to deference. He noted that Section 132.15(d) specifically provided that real property that produces the 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 Tax Appeal Tribunal affirmed the ALJ's decision, holding that the Department correctly interpreted Section 132.16 as requiring that gains from the sale or exchange of real property "are to be considered as entirely derived from or connected with the situs of such real property." The Tribunal, as had the ALJ, rejected the Lindes' attempt to rely on previous decisions, finding that those decisions did not concern real estate sales gains.

The Tribunal also generally rejected the Lindes' arguments that the application of Section 132.16 to allocate all the gain to New York was a violation of the Commerce Clause or the Privileges and Immunities Clause as discrimination against nonresidents. The Tribunal found the Department applied the

THE DEPARTMENT CORRECTLY INTERPRETED SECTION 132.16 AS REQUIRING THAT GAINS FROM THE SALE OR EXCHANGE OF REAL PROPERTY "ARE TO BE CONSIDERED AS ENTIRELY DERIVED FROM OR CONNECTED WITH THE SITUS OF SUCH REAL PROPERTY."

regulation in an "'evenhanded'" manner, exactly the same to resident and nonresident individual partners. However, the Tribunal did recognize that a potential detriment to nonresidents arose from the Department's method of computing accumulated depreciation, since nonresidents are required to take into account all of the accumulated depreciation on the property, but receive deductions only for an allocated portion of the depreciation, while resident individual partners are able to fully utilize the depreciation deductions that make up the accumulated depreciation component of the gain calculation. Therefore, the Tribunal required the Department to adjust the Lindes' basis in the property the partnership sold, to take into account only the depreciation for which they previously received a benefit. This adjustment, according to the Tribunal, remedied any potential discrimination .

Additional Insights. In dealing with the issue of alleged discrimination, the Tribunal resolved one problem that had not been addressed by the ALJ. As noted in the September issue of *New York Tax Insights* reporting on the ALJ decision, in earlier years the partnership was required to use a three-factor apportionment formula to allocate to New York only a portion of the costs and depreciation deductions attributable to the properties, but when the properties were sold was being required to allocate to New York the entire amount of depreciation recapture, which clearly seemed to result in a mismatch between the treatment of costs and deductions in the earlier years and the treatment of gain in later years. The Tribunal's decision eliminates this mismatch which would otherwise have resulted in a detriment to nonresidents.

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Failure to Establish Value of Assets in a Bulk Sale Leads to Liability for Entire Sales Tax Deficiency

By Kara M. Kraman

Upholding the decision of an Administrative Law Judge, the New York State Tax Appeals Tribunal held that the transfer of business assets from a son's company to his mother's company constituted a transfer in bulk under Tax Law § 1141(c), and that the mother's company was liable for the full amount of sales tax due by failing to establish the fair market value of the assets transferred. *Matter of Ultimat Sec.*, DTA No. 822991 (N.Y.S. Tax App. Trib., May 31, 2012).

Ultimat Security, Inc. ("Newco"), was a security business owned by Vera Drayton that provided guard services to commercial and residential properties. Prior to owning Newco, Ms. Drayton was employed by her son's security company, Ultimate Security, Inc. ("Oldco"). In May 2007, Newco acquired substantially all of the business assets of Oldco, including its customer list, office supplies, file cabinets, security uniforms, walkie talkies, and a used Ford Taurus. Oldco subsequently ceased to operate. The two companies did not execute a contract of sale and no consideration was exchanged.

In December 2007, the Department of Taxation and Finance requested information concerning the bulk transfer of assets from Oldco to Newco. In response, the Department received a letter from Ms. Drayton, as president of Newco, denying that a bulk sale had occurred. The Department disagreed and issued to Newco a Notice of Claim to Purchaser, advising Newco of a possible claim for New York State sales taxes due from Oldco. In February 2008, the Department issued a Notice of Determination against Newco as a bulk sale transferee in the amount of $346,800 for sales tax assessments due from Oldco for tax years 2000 through 2007.

New York law requires that the purchaser in a bulk sale transaction give notice of the sale to the Division at least 10 days prior to acquiring the assets of a selling company. A purchaser who fails to file a timely notice of bulk sale becomes liable for the sales and use taxes determined to be due from the seller to the extent of the greater of (i) the purchase price, or (ii) the fair market value of the business assets transferred. Tax Law § 1141(c). The purchaser in a bulk sale includes "any person who, as part of a bulk sale, purchases or *is the transferee or assignee* of business assets." 20 NYCRR 537.1(e) (emphasis added).

The ALJ held, and the Tribunal agreed, that Oldco's transfer of its assets to Newco clearly constituted a bulk sale, dismissing the taxpayer's assertion that there was no contract of sale or money exchanged as irrelevant to determining whether a bulk sale took place. The Tribunal also rejected the taxpayer's argument that its liability should be limited to $12,250, the amount it alleged to be the fair market value of the assets transferred.

As substantiation of the fair market value of the assets, Newco submitted a list of the transferred assets with estimated purchase prices provided by Ms. Drayton's son, whose company was the bulk sale seller. The list of assets did not include goodwill or other intangible assets. No purchase invoices, appraisals of the assets, witness testimony, or federal income tax returns with depreciation schedules were provided by Newco to substantiate these values. Citing the lack of any substantiation of the value of the transferred assets, the Tribunal affirmed the ALJ's determination that Newco failed to meet its burden of proof of establishing a fair market value for the transferred assets. Accordingly, the Tribunal held that Newco was liable for the full $346,800 owed by Oldco.

Additional Insights. The Tribunal's decision is a reminder of the importance of carefully documenting transactions between related business owners. In this case, the mother alleged that her company received assets worth only $12,250 from her son's company, yet her company ended up being liable for the full $346,800 sales tax assessment against her son's company before the bulk sale. Had the mother taken care to properly substantiate the values of the assets transferred, she might have avoided liability for a substantial portion of the $346,800 due.

Entitlement to QEZE Credits Affirmed by Tribunal

By Hollis L. Hyans

In *Matter of Bombardier Mass Transit Corp.*, DTA No. 822999 (N.Y.S. Tax App. Trib, June 7, 2012), the New York State Tax Appeals Tribunal affirmed the decision of an Administrative Law Judge holding that the petitioner was permitted to claim qualified empire zone enterprise ("QEZE") credits for real property taxes.

As discussed in the May 2011 issue of *New York Tax Insights*, the taxpayer, Bombardier Mass Transit Corp., had claimed entitlement to QEZE credits for real property taxes based on a payment in lieu of taxes ("PILOT") agreement. The Department of Taxation and Finance argued that the petitioner failed to meet

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Entitlement to QEZE Credits Upheld

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the requirement under the statute that it had made payments in lieu of taxes "pursuant to a written agreement entered into between the QEZE and the state, municipal corporation, or public benefit corporation." Tax Law § 15 (former[e]). Bombardier was relying on an agreement dated May 1, 1998 (the "PILOT 3" agreement), under which it assumed all rights and obligations of its parent to various properties in Plattsburgh, New York, and agreed to perform all of the obligations of its parent, including payment in lieu of taxes owed under previously existing agreements.

The ALJ found that Bombardier had met its burden of proving that PILOT 3 was a written agreement under the statute, and rejected all the Department's challenges, which included arguments that a copy of the agreement had not been produced until relatively late in the audit, that it did not specifically enough incorporate earlier agreements and descriptions of the properties, and that the petitioner's witness lacked personal knowledge of agreements that had been entered into before that time. Specifically, the ALJ had found the challenged witness's testimony "credible and helpful" and noted that "relevant and probative hearsay is admissible in an administrative proceeding." The ALJ found all of the terms in the PILOT 3 agreement clear enough to establish that the petitioner had agreed to make all of the payments in lieu of tax that its parent and predecessor had previously been obligated to make, and was entitled to the credits.

THE TRIBUNAL FOUND THAT THE DEPARTMENT COULD NOT IMPOSE AN INTERPRETATION "SO 'NARROW AND LITERAL AS TO DEFEAT [THE] SETTLED PURPOSE' OF THE EXEMPTION."

The Tribunal affirmed the ALJ's decision in all respects, finding that Bombardier had established its position through clear and convincing evidence. Under the statute, in order to claim the credit, Bombardier was required to prove it was a QEZE during the relevant period and that it made payments in lieu of taxes pursuant to a written agreement with an eligible entity. Bombardier satisfied that burden by reference to the terms of PILOT 3, which incorporated prior agreements and met the written agreement required by the statute. Despite acknowledging that tax credits are "a particularized species of exemption from taxation" and thus governed by the rule that statutory exemptions are construed against the taxpayer, the Tribunal found that the Department could not impose an interpretation "so 'narrow and literal as to defeat [the] settled purpose' of the exemption." The Tribunal held that the Department's arguments were based on an overly narrow interpretation of the statute, and rejected those arguments because they would "substantially reduce the latitude afforded to QEZEs and eligible entities in structuring their written PILOT agreements."

Additional Insights. Establishing entitlement to tax exemptions brings a higher-than-usual burden, since it is a basic principle of statutory interpretation that tax exemptions are construed strictly against taxpayers. Here the Tribunal recognized that, despite the higher burden, the narrow interpretation of the requirements urged by the Department defeated the very purpose for which the exemption was intended—to provide benefits to QEZEs and encourage them to make investments in New York State, as Bombardier did by opening a railcar manufacturing plant in the City of Plattsburgh, which the Tribunal specifically found attracted jobs and business to the area. This was exactly the purpose for which the Empire Zones Program was intended.

Environmental Testing and Monitoring Services Held Subject to Sales Tax

By Irwin M. Slomka

Is a taxpayer that pays for environmental testing and monitoring services also required to pay sales tax on those portions of the services that do not involve the environmental cleanup of real property? A New York State Administrative Law Judge, applying the "primary function" test, has held that the services in their entirety constitute "maintaining, servicing or repairing real property," and thus are subject to New York State sales tax. *Matter of Exxon Mobil Corp.*, DTA No. 823437 (N.Y.S. Div. of Tax App. May 24, 2012).

Exxon Mobil owned and operated retail gas stations in New York. Under New York law and regulations, it is required to comply with rules for the investigation, cleanup and removal of petroleum discharges at those sites. Once a petroleum discharge was discovered, Exxon Mobil reported the incident to the New York State Department of Environmental Conservation ("DEC"), was assigned a "spill number," and was then required to perform an environmental investigation to determine the adverse effects

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Environmental Testing Services Subject to Sales Tax

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upon adjacent properties, such as homes and wells. Exxon Mobil hired third-party environmental consultants to perform the required environmental testing and monitoring services. Following the preparation of the consultant's report, it was then determined, under DEC requirements, whether remediation of a site was required. Remediation of a site involves installation of a remediation system, followed by periodic sampling, testing, and monitoring; replacement of contaminated soil; the removal of storage tanks; and the disposal of waste.

The decision describes in great detail the procedures that were involved in the performance of the environmental testing (through soil and groundwater sampling), installation of monitoring wells, and the analysis and reporting of the results. Based on the contractor's analysis, a determination was then made whether remediation was necessary, although that determination sometimes required several years of testing. The factual record in the case did not indicate the percentage of spill sites that eventually required remediation. In most instances, the consultant providing the testing and monitoring services also provided any related remediation services.

Exxon Mobil did not pay sales tax on charges for testing and monitoring services that were (i) performed prior to any remediation or (ii) performed after remediation was completed (*i.e.*, post-remediation testing and monitoring). Exxon Mobil did not contest the imposition of sales tax on testing, monitoring, and remediation after the DEC approved a corrective remediation plan, and prior to shutdown of the remediation system.

The Department of Taxation and Finance asserted that sales tax was due on all the testing and monitoring services provided to Exxon Mobil, even if no remediation was performed on the site, including both pre- and post-remediation testing and monitoring. The Department maintained that the testing and monitoring constituted the taxable service of "maintaining, servicing or repairing real property" under Tax Law § 1105(c) (5). Exxon Mobil took the position that the services did not fall within any of the taxable services enumerated under the sales tax law.

The Administrative Law Judge applied the "primary function" test for taxability, analyzing the case by focusing on "the service in its entirety," rather than by reviewing each component of the service. The ALJ held that, looking at the services as a whole, "the primary function of the services was to enable [Exxon Mobil] to satisfactorily clean up or resolve a spill for which it was responsible." Citing to 20 NYCRR 527.7[a][1], the ALJ concluded that the services "*relate to* keeping real property in a condition of fitness, efficiency, readiness or safety or restoring to such condition" (emphasis added), regardless of whether the activities involve the actual repair or maintenance of the property.

LOOKING AT THE SERVICES AS A WHOLE, "THE PRIMARY FUNCTION OF THE SERVICES WAS TO ENABLE [EXXON MOBIL] TO SATISFACTORILY CLEAN UP OR RESOLVE A SPILL FOR WHICH IT WAS RESPONSIBLE."

Addressing Exxon Mobil's contention that the initial testing and monitoring did not necessarily lead to remediation in all cases, and thus that each component should be analyzed separately, the ALJ found that since a spill occurrence already indicated some level of disrepair at a site, the testing was merely to determine the extent of the disrepair and was part of an overall service relating to the real property. Moreover, according to the ALJ, under the Department's regulations, "diagnostic services" without additional repair fall within the definition of "maintaining, servicing and repairing" property (although the cited regulation, 20 NYCRR 527.5[a][3], ex. 6, deals with *tangible* personal property). The ALJ analogized the initial testing and monitoring to safety inspections performed at nuclear power plants, which the former State Tax Commission found taxable, regardless of whether repairs were actually made to the plant. *Matter of Rochester Gas and Elec. Corp.*, State Tax Comm'n, Mar. 6, 1985.

As for the post-remediation testing and monitoring, the ALJ concluded that these services were even more closely linked to remediation, since they were only performed in the event there had been actual remediation performed at the site. Although the ALJ upheld the sales tax assessment, he did reject the Department's alternative argument that the services constituted the installation of taxable personal property–*i.e*, the monitoring wells at the site, which are normally taxable under Tax Law § 1105(c)(3), finding that the monitoring wells were an incidental part of the overall service being provided.

Additional Insights: The ALJ is correct in concluding that it is the "primary function" of a service, and not its individual components, that determines whether it is subject to sales tax. However, it is less clear whether, where no remediation is *ever* performed, the initial testing and monitoring services should be

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Environmental Testing Services Subject to Sales Tax

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taxable even under the primary function test. If Exxon Mobil had been able to show specifically which portion of the initial testing and monitoring services never resulted in actual remediation, might it have lead to a different tax result with respect to those services? Of course, this could then present a tax compliance dilemma, since neither the taxpayer nor the contractor would know at the time of invoicing if the charges for initial testing and monitoring were, in fact, taxable. Also it is unclear whether even the primary function test would have resulted in taxation of initial testing and monitoring services if there had been a separate and distinct agreement between the parties for the performance of those initial services.

New Tax Credits, Exemptions and Licenses for Craft Brewers

By Hollis L. Hyans

In the wake of a court order that nullified an exemption from the alcoholic beverages tax on distributors and noncommercial importers of beer for small New York breweries, *see* TSB-M-12(1)M (N.Y.S. Dep't of Taxation & Fin., Apr. 13, 2012), new replacement legislation has been enacted with the goal of strengthening New York's craft beer industry. The legislation proposes three separate new provisions that provide refundable tax credits and exemptions from the annual liquor authority fee, and allow craft brewers greater ability to sell their products.

New York Tax Law § 424 imposes taxes on beer, wine, liquor, and other alcoholic beverages. In 2009, a provision was added to Tax Law Section 424(6) allowing an exemption from the tax on the first 200,000 barrels of beer brewed in New York, and sold or used in New York, in each calendar year, by a brewer whose principal executive office is located in New York. The law was challenged as violating the U.S. Constitution, and on March 28, 2012, the New York State Supreme Court entered a Stipulation of Settlement and Judgment, which provided that, with no admission on the merits by either party, Tax Law Section 424(6) is unconstitutional and of no force and effect. A settlement payment of $160,000 was also made to plaintiff and its attorneys. *Shelton v. N.Y.S. Liquor Auth.*, Index. No 7893-06 (Sup. Ct. Albany Cty. Mar. 28, 2012).

According to the announcement made by Governor Cuomo regarding the new legislation, small brewers in New York will "fare at least as well as they did under the prior exemption." The legislation includes the following new provisions:

Tax Credits. Any brewery that produces 60 million or fewer gallons of beer in New York would be eligible for a refundable tax credit against New York State personal income and business taxes, in the amount of 14¢ per gallon for the first 500,000 gallons produced in New York, and 4.5¢ per gallon for the next 15 million gallons.

Exemption from Liquor Authority Fee. Breweries that produce brands of 1,500 barrels or less annually (regardless of location) will be exempt from the $150 annual brand label fee.

Creation of a Farm Brewery License. This provision creates a new license that will allow craft brewers to sell New York State labeled beer, wine, and liquor at their retail outlets; obtain licenses to operate restaurants, conference centers, and hotels; conduct tastings; and sell related products such as beer-making equipment and supplies, foods at tastings, and souvenir items.

Additional Insights. The previous exemption that was available only to entities whose principal executive office is within the State seemed to be an obvious violation of the Constitution, under such cases as *Bacchus Imports, Ltd., et al. v. Dias, Dir. of Taxation of Hawaii*, 468 U.S. 263 (1984), in which the United States Supreme Court held unconstitutional a Hawaii statute that exempted locally produced alcoholic beverages from the liquor tax as violating the commerce clause, since the statute had both the purpose and effect of discriminating in favor of local products. It remains to be seen whether the new version of the statute, to the extent it provides benefits available only to New York State craft breweries, will withstand constitutional challenge should one be brought. Structuring the benefit as the provision of a tax credit against personal income and business taxes, rather than as an exemption, may not necessarily insulate the new law from challenge.

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Insights in Brief

Allegations of Due Process Violation in Calculating Property Tax Rates Allowed to Proceed

Owners of commercial real property located in the City of Beacon brought an action against the City seeking repayment of real property taxes based on alleged miscalculation of the taxes due, and included claims under 42 U.S.C. § 1983 against a former City Administrator for alleged deprivation of rights under color of state law. In *Way v. Beacon*, 2012 NY Slip. Op. 04737 (App. Div. 2d Dep't June 13, 2012), the appellate court rejected the plaintiffs' claims based on the Equal Protection Clause, since no "invidious discrimination" was alleged, finding that the creation of different classes for purposes of taxation was permissible, as long as the classification was reasonable and the taxes uniform. However, the court held that the claims based on alleged violation of the Due Process Clause should not be dismissed, since, taken as true for the purposes of a motion to dismiss, they alleged that the miscalculation of rates was done deliberately, at the direction of the former City Administrator, and if found to be true would demonstrate "an aggravated pattern of misuse of the City's taxing power."

Airplane and Helicopter Did Not Qualify for Sales Tax Exemption for Commercial Aircraft

In *Matter of John P. Reilly D/B/A Construction Concepts*, DTA No. 823544 (N.Y.S. Div. of Tax App., May 24, 2012), an Administrative Law Judge held that a sole proprietor's purchases of an airplane and a helicopter were subject to sales and use taxes because neither qualified as commercial aircraft *primarily* engaged in intrastate, interstate, or foreign commerce under Tax Law §§ 1115(a)(21) and 1101(b)(17). The sole proprietor alleged that he met the statutory definition for property used "by the purchaser of the aircraft primarily to transport such person's tangible personal property in the conduct of such person's business," but admitted that he also used the aircraft for non-work-related trips. The ALJ concluded the sole proprietor did not sustain his burden of proof to establish that either the helicopter or the airplane was used primarily in his work so as to qualify as commercial aircraft.

Department Provides Mortgage Recording Tax Guidance for Mortgages Securing "Breakage Costs" Under Interest Rate Swap Agreements

The Department of Taxation & Finance has issued a *Tax Bulletin* to provide guidance on when mortgage recording tax will apply to "breakage costs" under an interest rate swap agreement that is secured by a mortgage on real property. *Tax Bulletin* TB-MR-30, June 5, 2012 (*Application of the Mortgage Recording Tax to Breakage Costs Secured Under Interest Rate Swap Agreement*). A swap agreement protects the property owner against mortgage interest rate fluctuations and, in certain cases, requires the borrower to pay the lender a "breakage cost" in the event the borrower breaks the contract. In those cases, the mortgage on the real property will often also secure the breakage costs. The *Tax Bulletin* explains when such breakage costs will be considered incidental amounts secured by the mortgage which are not subject to mortgage recording tax. However, if the breakage costs are secured in a separate and distinct mortgage, that mortgage would be subject to the tax.

Movies Received by Satellite Not Subject to Sales Tax

The New York State Department of Taxation and Finance ruled that movies received by satellite transmission are not subject to sales tax because they are sales of intangible property. *Advisory Opinion*, TSB-A-12(10)S (N.Y.S. Dep't of Taxation & Fin., May 14, 2012). In contrast, movies delivered by hard drive, tape, or disk are subject to sales tax because they are sales of tangible personal property.

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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
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