Volume 2, Issue 1

January 2011

MoFo

New York Tax Insights

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IN THIS ISSUE

Top 10 New York Tax Highlights for 2010

By Irwin M. Slomka

Although we began publishing New York Tax Insights only two months ago, we at MoFo have been keeping an eye on important New York State and City developments throughout the past year. As we begin a new and exciting year, here is our own list of the top 10 New York tax highlights for 2010.

(Continued on page 2)

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Top 10 NY Tax Highlights

(Continued from Page 1)

1. New York "Amazon" tax upheld on Appeal.

In what may be the most watched sales tax case not only in New York but throughout the United States, in November the Appellate Division, First Department, held that New York's "Amazon" tax, which is actually a statutory presumption of in-state solicitation, and therefore a presumption of nexus for sales tax purposes, is not facially unconstitutional. *Amazon.com, LLC v. New York State Dep't of Taxation & Fin., et al.*, 2010 NY Slip Op. 7823 (1st Dep't, Nov. 4, 2010). Although the Court remanded the case for further proceedings to determine whether the tax was unconstitutional "as applied," Amazon filed a motion on December 6, 2010 seeking permission to appeal to the Court of Appeals, New York's highest court. Many observers believe that this groundbreaking case, which the First Department acknowledged has "far-reaching ramifications," will eventually be heard by the U.S. Supreme Court.

2. New York State issues policy memorandum broadly interpreting the scope of the sales tax on information services.

In perhaps its most controversial administrative pronouncement in 2010, the Department of Taxation and Finance formally announced in a memorandum that it would be more broadly interpreting the scope of the long-standing sales tax on information services. "Sales and Compensating Use Tax Treatment of Certain Information Services," TSB-M-10(7)S (N.Y.S. Dep't of Taxation & Fin., July 19, 2010). Among the more troublesome aspects of the TSB-M was the State's view that, in determining whether the services constitute information services, the ultimate purpose for which the purchaser is acquiring the services is irrelevant under the "primary function" test. Also notable was the state's position that the furnishing of information that is "widely accessible" will always be considered a taxable information service. Despite the Department's more expansive approach to information services, in at least two recent cases (*Matter of Nerac Inc.*, DTA Nos. 822568 & 822651 (N.Y.S. Div. of Tax App., July 15, 2010) and *Matter of Telecheck Servs., Inc.*, DTA No. 822275 (N.Y.S. Div. of Tax App., Nov. 5, 2009), it chose not to file exceptions to adverse ALJ determinations which limited the scope of the taxation of information services.

3. Tax Appeals Tribunal provides relief under the personal income tax for taxpayers seeking to prove day count for "statutory residency."

The Tax Appeals Tribunal issued its first decision in several years regarding an individual's ability to prove his or her whereabouts on specific days under the 183-day rule for statutory residency. *Matter of Julian H. Robertson*, DTA No. 822004 (N.Y.S. Tax App. Trib., Sept. 23, 2010). It is a potentially important decision in a problematic area—what if there is no dispositive document regarding an individual's whereabouts on a particular day? Ruling for the taxpayer, the Tribunal held that the 183-day rule does not require that an individual provide to State auditors an "objectively verifiable piece of documentary evidence establishing an individual's whereabouts on every day in question," and held that credible testimony evaluated in light of surrounding events could suffice to meet the burden of proof. The Tribunal decision was accompanied by a rare dissenting opinion that the taxpayer did not prove his whereabouts by "clear and convincing evidence."

4. Two-year temporary deferral of certain tax credits enacted into law.

Faced with a severe budgetary crisis this past year, the New York State Legislature took the unprecedented step of enacting a temporary two-year deferral of a variety of business tax credits for corporate and individual taxpayers with more than $2 million in those credits in any year. Laws 2010, Ch. 57. Generally termed a "two year" deferral, the deferred credit actually will be paid out over an additional three year period beginning in 2013. Despite the broad scope of the legislation, some breathed a sigh of relief that, given the State's dire financial condition, the tax credit deferrals weren't even more onerous. The law went into effect for tax years beginning on or after January 1, 2010.

5. Repeal and subsequent phase-in of sales tax exemption for clothing and footwear.

As a particularly visible revenue raiser in a bad fiscal year for New York State, the Legislature significantly scaled back the sales tax exemption for clothing and footwear costing less than $110, which had been touted as a way of encouraging shoppers to buy clothing in New York rather than in neighboring New Jersey. The complete repeal is only temporary, however, with a gradual return of the full exemption over a 1½ year period as follows: (i) initially, there is a complete repeal of the exemption for clothing and footwear (October 2010-March 2011); (ii) then the exemption is reinstated for clothing and footwear costing less than $55 per item (April 2011-March 2012); and (iii) finally, the exemption is scheduled to return to the $110 threshold beginning April 1, 2012.

6. Ongoing efforts to tax sales of cigarettes on Indian reservations.

In yet another effort to stem the flow

(Continued on page 3)

Top 10 NY Tax Highlights

(Continued from Page 2)

of untaxed cigarettes sold on Indian reservations, this summer the New York State Legislature amended the Tax Law to require wholesale dealers to collect cigarette excise taxes and prepaid sales tax for cigarettes sold for resale on an Indian reservation to non-Indians, effective September 1, 2010. Laws 2010, Ch.134. The Department also adopted emergency rules. Extensive litigation followed, with actions being brought in both Federal and New York State courts to enjoin enforcement of the new law and regulations. Temporary restraining orders were initially granted, although they were eventually lifted. At year end, the litigation is ongoing, and in *Seneca Nation of Indians v. Paterson,* No. 10-CV-687A (W.D.N.Y. Oct. 14, 2010), the plaintiffs recently filed an appeal of the District Court's denial of a preliminary injunction.

7. New York City loses long-standing dispute over taxation of foreign diplomatic missions.

In a decision involving a nearly eight-year real property tax dispute between the City of New York and certain foreign missions to the United Nations, the Second Circuit for the U.S. Court of Appeals, reversing a District Court decision, held that a U.S. State Department Notice—issued in 2009 while this appeal was pending—declaring invalid New York City real property tax liens against the Indian and Mongolian Missions to the United Nations was lawful and binding retroactively. *City of New York v. Permanent Mission of India to the United Nations* Dkt. Nos. 08-1805-CV & 08-1806-CV (2d Cir. Aug. 17, 2010). The City of New York had argued that the portion of the premises used as residences for mission employees and their families did not qualify for exemption. The Second Circuit decision may not be the final word. On November 9, 2010, New York City filed a petition for writ of *certiorari* with the U.S. Supreme Court (No. 10-627), and the Court extended the time to file a response until January 12, 2011.

8. Draft "Corporate Tax Reform" bill unveiled but its future remains unclear.

During 2010, the Department of Taxation & Finance continued work on its self-described "Corporate Tax Reform" legislation, a Department initiative begun in 2008 and developed with input from members of the New York business community. According to a revised draft bill distributed in 2010 to professional organizations and industry groups, the legislation would make sweeping changes to the current New York State corporate income and bank tax regimes, rivaling the scope of the changes to Article 9-A in 1944. Among the changes contemplated are full unitary combined reporting, the elimination of the exemption for income from subsidiary capital, and the complete exemption from tax of a narrowed definition of investment income, accompanied by a rate reduction. The draft proposal was intended to apply to tax years beginning on or after January 1, 2011. For various reasons—including the protracted delays in obtaining a budget bill this past year and Governor Patterson's announcement that he would not seek re-election in 2010—the Department did not move to have the draft bill formally introduced in the Legislature in 2010. With a new governor taking office in January 2011, its prognosis for passage in the upcoming year in its existing form remains uncertain.

9. Office of the Taxpayer Rights Advocate receives positive response from public.

Created in late 2009, but becoming fully operational in 2010, the Office of the Taxpayer Rights Advocate within the Department continued to take a proactive role in addressing individual taxpayer disputes not readily resolvable through normal channels, as well as more systemic problems within the Department. Among the systemic issues being addressed by the new office in 2010 was the drafting of legislation to reform the onerous "responsible person" liability of limited liability company members for sales tax owed by the LLC, as well as attempts to make the New York State Bureau of Conciliation more effective. The response from the public to the new office has been uniformly positive, and many practitioners are hopeful that the establishment of the office will be made part of the tax law itself in the upcoming year.

10. Legislature amends taxation of nonresident shareholders of S corporations, retroactively reversing a Tax Appeals Tribunal decision.

Can the New York State Legislature pass a law that *retroactively* revokes a Tax Appeals Tribunal decision? Apparently the Legislature and the Tax Department think so. In 2010, the Legislature enacted a law that not only reversed a 2009 Tribunal decision in *Matter of Gabriel S. Baum*, but made it retroactive to January 1, 2007. Laws 2010, Ch. 57. DTA Nos. 820837 & 820838 (N.Y.S. Tax App. Trib., Feb. 12, 2009). In *Baum*, the Tribunal upheld a nonresident S corporation shareholder's reporting position that his sale of S corporation stock, which he treated as a deemed asset sale for federal income tax purposes, should nonetheless be characterized as a stock sale for State income tax purposes. As a result, the Tribunal held that the gain was not taxable New York source income of the nonresident shareholder. The Department, believing that *Baum* was wrongly decided, proposed legislation to reverse it, but took the highly unusual step of seeking to have the law apply retroactively to all open years. In the legislation that eventually passed,

(Continued on page 4)

Top 10 NY Tax Highlights

(Continued from Page 3)

the reversal was made retroactive only to January 1, 2007. The significance of the January 1, 2007 date is unclear, but it may have been selected to insure that any potential refund claims arising because of the *Baum* decision would be time-barred.

Deficiency Barred Under Doctrine of Equitable Recoupment, But No Refund Allowed

By Hollis L. Hyans

The New York City Tax Appeals Tribunal, revisiting a case in which it had allowed the filing of combined returns, has ordered that the recomputed deficiency asserted by the Department of Finance be set aside, but has also denied the Petitioners' claim for refund. *Matter of American Banknote Corp.*, TAT(E)03-31, 32 and 33(GC) (N.Y.C. Tax App. Trib., Dec. 3, 2010).

The original litigation concerned whether a group of companies were entitled to file combined returns under Administrative Code § 11-605.4 for the tax years 1990 through 1992. The Tax Appeals Tribunal, reversing an ALJ determination, held that the Petitioners were permitted to file combined returns. *American Banknote Corporation*, TAT(E)03-31, 32 and 33 (N.Y.C. Tax App. Trib., Nov. 14, 2008) (the "Original Tribunal Decision"). In its last sentence, the Original Tribunal Decision cancelled the Notices of Determination that has been issued asserting a deficiency of General Corporation Tax ("GCT") on a separate-company basis, "except to the extent [those Notices] reflect undisputed Audit adjustments that would apply to Petitioners' combined GCT returns for the Tax Years."

After the Original Tribunal Decision, the Department's auditor recalculated Petitioners' combined GCT liability and concluded there was a deficiency in the principal amount of $11,875.37. Petitioners reviewed the calculations and advised that the recalculation did not include an adjustment to eliminate the investment of members of the combined group in other combined members (the "intercompany eliminations"). The auditor prepared a revised calculation, showing that incorporation of the intercompany eliminations resulted in a GCT overpayment in the principal amount of $24,262.10. While agreeing with the numerical calculation, the Department contended that the inclusion of the intercompany eliminations in the revised calculation reflected a mistake make by Petitioners on their original combined GCT returns for the tax years, that such computations were not specifically addressed in the Original Tribunal Order directing that the Department reflect only "undisputed Audit adjustments," and that any refund based on the revised recalculation was now time-barred. The Department sought to collect its asserted GCT deficiency of $11,875.37, plus interest.

The Tribunal dealt expeditiously with the Department's attempt to collect a deficiency. It held that the doctrine of equitable recoupment allows the Petitioners to assert the intercompany eliminations as a defense to an asserted GCT deficiency, whether or not a separate refund claim could timely be filed. However, the doctrine of equitable recoupment did not allow the Petitioners to claim a refund, over and above eliminating the amount of an asserted deficiency, unless the refund claim was timely or the Petitioners could show that the Commissioner's special refund authority under Code § 11-687.4 should apply.

THE DEPARTMENT OF FINANCE CONTENDED THAT THE INCLUSION OF THE INTERCOMPANY ELIMINATIONS IN THE REVISED CALCULATION REFLECTED A MISTAKE MAKE BY PETITIONERS ON THEIR ORIGINAL COMBINED GCT RETURNS FOR THE TAX YEARS.

The Tribunal reviewed each of the possible grounds for a timely refund claim. The usual time periods, the later of three years from filing the return or two years from payment, had clearly expired. Code § 11-678.6 provides that where a timely petition is filed protesting a GCT deficiency, no separate refund claim is required, and a refund is allowed in four circumstances. Three of those—refunds of amounts collected in excess of an amount computed in accordance with a Tribunal decision, amounts collected after the time to make a levy for collection had expired, and refunds based on Federal or State changes—did not apply. The only possible ground was whether a final decision of the Tribunal determined that an overpayment was made, but the Tribunal held that the Original Tribunal Decision did not determine the issue of a GCT refund based on the combined returns resulting from the intercompany eliminations, since the issue had never been raised during the course of the ALJ or earlier Tribunal proceedings.

(Continued on page 5)

Deficiency Barred But No Refund Allowed

(Continued from Page 4)

The Petitioners argued that the refund should be granted by exercising the Department's authority under Code § 11-687.4, which allows refunds where no questions of fact or law are involved and moneys have been erroneously or illegally collected under a mistake of facts, without regard to any period of limitations. The Tribunal held that it could not consider Petitioners' claim under Code § 11-687.4 because the claim had never been presented to the Commissioner, although it found that the Petitioners were not precluded from pursuing such a claim directly with the Department.

Additional Insights

This case stands as an important reminder of two well-established doctrines. First, the doctrine of equitable recoupment allows a claim to be made to reduce or eliminate an asserted deficiency, without regard to the expiration of any statute of limitations, and similarly allows an item that could have been the basis for an otherwise time-barred deficiency to be asserted as a defense against a refund claim for the same tax for the same period. A tax department is limited to collecting only the correct amount of tax for a period, and similarly a taxpayer may receive in refund only an amount that it incorrectly overpaid.

Second, taxpayers must exercise great effort to raise all possible issues during the course of a hearing, and draft their pleadings as broadly as possible to take into account any refund opportunities that may be developed during the course of a trial. Sometimes, potential issues are discovered only when all attention is focused on a particular return for particular years, and issues or opportunities that may not have been originally thought worthwhile could develop new importance.

Interest Due on PIT Refund from Due Date of Original Return

By Hollis L. Hyans

The Department of Taxation and Finance has issued an Advisory Opinion concluding that interest on a personal income tax refund resulting from the carryback of a net operating loss, if not refunded to a taxpayer within 45 days of the claim for refund, should be computed from the original due date of the loss year return, without regard to extensions of time to file. Advisory Opinion, TSB-A-10(10)I (N.Y.S. Dep't of Taxation & Fin., Oct. 28, 2010).

The taxpayers had timely filed an extension request for their 2008 New York State personal income tax return, and then timely filed their 2008 return reflecting a loss prior to the extended October 15, 2009 due date. In November 2009, they sought to carry back their 2008 loss to the 2004 tax year. The taxpayers received a refund for the full amount requested, but only received interest computed from the extended October 2009 actual filing date of the 2008 return, rather than from April 15, 2009, the original due date of the return for the loss year without regard for extensions.

The Advisory Opinion reviewed the terms of Tax Law § 688, which provides that interest is allowed on claims for refund if they are not paid or credited within 45 days of a claim. The statute contains no explicit provision addressing interest on refunds arising from net operating loss carrybacks not paid within 45 days of a claim for refund when the return for the loss year was filed on or before its extended due date. Therefore, the Department looked to the interpretations of IRC § 6611, which similarly governs interest on claims for refund based on the carryback of a loss or credit, and on which Tax Law § 688 is modeled. The Department relied on Federal legislative history, an example in the Internal Revenue Manual (IRM 21.5.9.5.40 [05-17-2010]), and an IRS Private Letter Ruling addressing the issue (IRS Priv. Ltr. Rul. 8350109, Sept. 15, 1983).

INTEREST ON A PERSONAL INCOME TAX REFUND RESULTING FROM THE CARRYBACK OF A NET OPERATING LOSS, IF NOT REFUNDED TO A TAXPAYER WITHIN 45 DAYS OF THE CLAIM FOR REFUND, SHOULD BE COMPUTED FROM THE ORIGINAL DUE DATE OF THE LOSS YEAR RETURN, WITHOUT REGARD TO EXTENSIONS OF TIME.

Tax Law § 688(d) provides that an overpayment caused by a carryback is not deemed to have been made prior to the "filing date" for the taxable year in which the net operating loss arose, determined without regard to extensions of time to file. Following Federal interpretations, the Department concluded that, because the return for the loss year was timely filed before the extended due date, interest would begin not from the actual extended due date, since it was not a late return, but from the earlier April 15, 2009 date,

(Continued on page 6)

Interest Due on PIT Refund

(Continued from Page 5)

the original due date of the return for the loss year determined without regard to extensions.

Additional Insights

This Advisory Opinion re-states the policy that, in the absence of specific state guidance, New York State generally looks to and follows Federal interpretations of sections of the Internal Revenue Code on which New York's own provisions are based. The Department noted that the New York Court of Appeals has endorsed this policy, and that the Tax Appeals Tribunal has relied upon a Federal Revenue Ruling in interpreting New York interest provisions, *Matter of Unicorp Am. Corp.*, DTA No. 811873 (N.Y.S. Tax App. Trib., Dec. 28, 1995), a case in which the Tribunal noted that it found "particularly helpful" a Federal Revenue Ruling which interpreted an analogous provision of the Internal Revenue Code. Where there is a Federal interpretation of an analogous statute, the general policy of conforming State interpretations to Federal treatment is commendable and avoids inconsistency and needless uncertainty.

THIS ADVISORY OPINION RE-STATES THE POLICY THAT, IN THE ABSENCE OF SPECIFIC STATE GUIDANCE, NEW YORK STATE GENERALLY LOOKS TO AND FOLLOWS FEDERAL INTERPRETATIONS OF SECTIONS OF THE INTERNAL REVENUE CODE.

Tax Department Issues New Forms for Temporary Tax Credit Deferrals

By Irwin M. Slomka

The Department of Taxation and Finance has just issued Forms IT-500 ("Income Tax Credit Deferral") and CT-500 ("Corporation Tax Credit Deferral"), new tax forms for 2010 to be used by individuals and corporations, respectively, in computing the recently enacted temporary deferral of certain tax credits, applicable to tax years beginning on or after January 1, 2010. The forms appear to answer an important question regarding when the deferral is triggered in the case of credits generated by pass-through entities.

Under the new tax credit deferral law, enacted in 2010 in light of New York State's budget crisis, individuals and corporations claiming various business tax credits (such as the investment tax credit and Brownfields tax credit) are subject to a two year deferral. The deferred amounts are then phased in over an additional three year period beginning in 2013. The Department issued a memorandum explaining how the temporary deferral would work. "Temporary Deferral of Certain Tax Credits," TSB-M-10(5)C & TSB-M-10(11)I (N.Y.S. Dep't of Taxation & Fin., Sept. 13, 2010).

Notably, the tax credit deferrals apply only where a taxpayer's total tax credits for the year exceed $2 million. The new form makes clear that, in the case of tax credits generated by partnerships, most New York S corporations and limited liability companies treated as partnerships, which then pass through the credits to their partners, shareholders and members, the $2 million threshold for deferral is determined at the partner, shareholder and member level. Therefore, for example, even if a partnership generates more than $2 million in enumerated tax credits for the year, the new tax deferral form is not filed by the partnership, but by the individual and corporate partners. The $2 million threshold for deferral of tax credits will only apply to a partner, shareholder or member that claims such credits in excess of $2 million.

Repayment of Embezzled Funds is Not a Deductible Business Loss

By Hollis L. Hyans

A New York State Administrative Law Judge has held that a taxpayer cannot claim trade or business losses for embezzled funds that she repaid, and could not receive the benefits of loss carryback provisions. *Matter of Hanna Shin*, DTA Nos. 822869 and 822992 (N.Y.S. Div. of Tax App., Nov. 24, 2010).

In 2007, the taxpayer pled guilty to grand larceny, and admitted stealing funds from her employer during 2004 through 2006 by created false invoices and diverting payments due the employer to companies controlled by the petitioner or an accomplice. She also kept for her own use additional funds paid by a client and intended for her employer. Under the terms of a plea agreement, she was required to make restitution to her employer, and to file amended federal, state, and local

(Continued on page 7)

income tax returns for 2005 and 2006, and original returns for 2007. In January 2008, she filed an amended NYS return for 2005, showing additional adjusted gross income and additional tax due. She then filed, in October 2008, a second amended return, seeking a credit or refund and claiming a net operating loss carryback from 2007, based upon "restitution to pay back fees," as well as increased Schedule C expenses, including expenses for supplies, meals and entertainment, consultants, travel, and formal wear.

The Division denied the refund claim and disallowed petitioner's deduction of the repayments, finding that she was not entitled to a Claim of Right credit for the repayment of the embezzled funds, and that they were not allowed as business expenses under IRC § 162. The Division also denied the additional business expenses for lack of supporting documentation.

The ALJ upheld the Division's denials. He noted, first, that petitioner failed to qualify for any Claim of Right deduction under IRC § 1341, which requires a taxpayer to restore in the taxable year an item that was included in a gross income under a Claim of Right in a prior taxable year. Although a taxpayer who embezzles funds must include those funds in gross income under IRC § 61, such income is not included under a Claim of Right for purposes of § 1341.

The ALJ also found that there was nothing in the record establishing that the petitioner was engaged in a trade or business during the years of embezzling. In her plea agreement, she admitted to using the business name she created to submit false invoices to her employer's customers in order to divert funds to herself, but failed to establish any activity that could be considered the carrying on of a trade or business that would allow her to deduct business expenses under IRC § 162(a). The ALJ also agreed with the Division that the petitioner failed to substantiate the additional claimed business expenses or to explain how the claimed expenses were related to her alleged business.

IN ORDER TO CLAIM THE BENEFIT OF THE FEDERAL CLAIM OF RIGHT DOCTRINE UNDER IRC § 1341, A TAXPAYER MUST RESTORE IN THE TAXABLE YEAR AN ITEM THAT WAS INCLUDED IN GROSS INCOME UNDER A CLAIM OF RIGHT IN A PRIOR YEAR, DEFINED BY TREASURY REGULATION § 1.1341-1(A)(2) AS AN ITEM INCLUDED IN GROSS INCOME BECAUSE IT APPEARED FROM ALL THE FACTS AVAILABLE IN THE YEAR OF INCLUSION THAT THE TAXPAYER HAD AN UNRESTRICTED RIGHT.

Additional Insights

In order to claim the benefit of the Federal Claim of Right doctrine under IRC § 1341, a taxpayer must restore in the taxable year an item that was included in gross income under a claim of right in a prior year, defined by Treasury Regulation § 1.1341-1(a)(2) as an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item, and that it was established after the close of the prior taxable year that the taxpayer did not have an unrestricted right to the item in question and had to make restitution. It does not apply to situations resulting from theft or embezzlement, and the ALJ noted that this "'claim of wrong'" rule denying the benefits of IRC § 1341 has been applied "in a variety of contexts involving intentional wrongdoing." Furthermore, since "embezzlement" is not a trade or business, repayment of embezzled funds cannot be deducted as trade or business losses under IRC § 162(c)(1).