MOFO
NEW YORK TAX INSIGHTS
Volume 8, Issue 9, September 2016

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Appellate Division Holds That NYS Tax Department Properly Withheld Documents Requested Under FOIL

By Kara M. Kraman

In a unanimous decision, the Appellate Division affirmed a decision of the Supreme Court, Albany County, which had upheld the New York State Department of Taxation and Finance's partial denial of a taxpayer's Freedom of Information Law ("FOIL") requests. *Matter of Moody's Corp. and Subsidiaries v. New York State Dep't of Taxation & Fin., et al.*, 2016 N.Y. Slip Op. 05612 (3d Dep't, July 21, 2016). The Appellate Division also reversed the lower court's decision to the extent that it had directed the Department to release certain additional documents.

Background. Moody's Corp., a credit rating agency, had filed FOIL requests with the Department seeking the audit file relating to an Article 9-A audit of Moody's, and all records "relating to the sourcing of credit rating receipts for tax years 2004 to present." The Department released certain responsive records, including portions of the Moody's audit file, but ultimately withheld several hundred pages as exempt from disclosure and released redacted versions of certain other documents. These withheld records included emails, draft agreements, a final closing agreement, draft correspondence, and correspondence from and regarding Moody's and non-party taxpayers, as well as other relevant documents.

Moody's challenged the Department's partial denial of its FOIL requests initially by commencing an Article 78 proceeding in the Supreme Court, Albany County. In response, the Department submitted to the Supreme Court judge for review two privilege logs (that do not appear to have previously been furnished to Moody's) and the documents that it had withheld or redacted. After conducting an *in camera* review, the judge held that an additional 13 unredacted pages and four redacted pages should have been provided to Moody's, but otherwise upheld the Department's FOIL denial. Both Moody's and the Department appealed.

Exemption for Tax Secret Documents. The New York State Freedom of Information law is contained in the Public Officers Law ("POL"). POL § 87(2)(a) provides that records that "are specifically exempted from disclosure by state or federal statute" are not subject to disclosure under FOIL. As is relevant here, Tax Law § 211(8)(a) provides that

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"it shall be unlawful for any tax commissioner [or] any officer or employee of the [Department]; . . . to divulge or make known in any manner the amount of income or any particulars set forth or disclosed in any report under [Tax Law Article 9-A]."

Exemption from Disclosure for Intra-/Inter-Agency Materials. POL § 87(2)(g) exempts from disclosure intra- or inter-agency materials that are not "statistical or factual tabulations or data, . . . instructions to staff that affect the public," or "final agency policy or determinations." Under the prevailing case law, this exemption from disclosure generally applies to records that are deliberative, *i.e.*, communications exchanged for discussion purposes not constituting final policy decisions.

[T]he court determined that the tax secrecy provisions of Tax Law § 211(8) are not limited to the tax returns themselves, but extend to "any document that reflects information included in a return."

Appellate Division Decision. After reviewing *in camera* documents withheld by the Department pursuant to POL § 87(2)(a) because they were protected by tax secrecy, the Appellate Division found that those documents were properly withheld. In so holding, the court determined that the tax secrecy provisions of Tax Law § 211(8) are not limited to the tax returns themselves, but extend to "any document that reflects information included in a return." The Appellate Division rejected the argument made by Moody's that otherwise tax secret documents should be released in redacted form to protect confidentiality, and reasoned that to hold otherwise would contravene the purposes of the statute: to protect personal privacy interests and to encourage voluntary compliance with the tax laws by preventing use of return information to harm the reporting taxpayer. The Appellate Division further noted that where, as here, a document is exempt from disclosure pursuant to statute, it may not be subjected to redaction.

The Appellate Division also affirmed the lower court's decision that the Department properly withheld certain documents because they were intra- or inter-agency materials exempt from disclosure pursuant to POL § 87(2)(g). In so holding, the Appellate Division rejected the argument that internal memoranda used to discuss and advance a position pending negotiations with a party, and records of a position taken during an audit, constitute disclosable final agency determinations, and held instead that they constituted "predecisional material, prepared to assist an agency decision maker in arriving at his or her decision," which need not be disclosed (citing *Xerox Corp. v. Webster*, 65 N.Y. 2d 131, 132 (1985)).

Finally, the Appellate Division reversed the lower court's determination in favor of Moody's that the Department should release an internal memorandum in which a Department employee proposed that an agency regulation be amended and an internal memorandum in which an agency employee sought approval of a tax determination regarding another taxpayer. The Appellate Division held that both memoranda were exempt from disclosure pursuant to POL § 87(2)(g) because they were intra- or inter-agency materials that were prepared to assist with governmental decision-making, and that the latter memorandum was also exempt from disclosure to the extent that it involved information protected by the tax secrecy provisions in Tax Law § 211(8).

Additional Insights.

This decision confirms that the tax secrecy provisions of the Tax Law which prevent the Department from disclosing taxpayer information apply not just to a taxpayer's tax returns, but to any document that reflects information included in the returns. The decision also applies a particularly broad interpretation of the exemption from disclosure for intra- or inter-agency materials that do not represent final agency policy, finding that positions taken by the Department during audit or in negotiations with a taxpayer do not qualify as final agency policy. Based on the *Moody's* decision, it is unclear what types of intra-agency communications regarding the conduct of an audit are properly disclosable under FOIL.

NYS Tax Department Issues Further Corporate Tax Reform Guidance on Its Website

By Irwin M. Slomka

Recent additions to the New York State Department of Taxation & Finance website regarding continuing developments under New York State Corporate Tax Reform – including revisions to the 2015 Article 9-A

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returns themselves – are a reminder of the usefulness of periodically monitoring the Department's website. In August 2016, the Department made several important additions to its website regarding corporate tax reform, including to its Frequently Asked Questions ("FAQs"), the device used most by the Department to provide updates:

- **Alien corporations that generate business losses in New York State may be combinable.** Under a newly-released FAQ, an alien corporation (that is, a corporation formed under the laws of a country other than the United States) that conducts a trade or business in New York State resulting in a loss that is effectively connected with a U.S. trade or business may be included in a combined Article 9-A return if it meets the requirements for combined returns, generally based on whether the alien corporation and an in-State affiliate meet the stock ownership and unitary business requirements.

  This makes clear that both the nexus and combined return protections available to alien corporations are inapplicable where the alien corporation has effectively connected income or losses.

- **No underestimated tax penalties will be imposed for 2015 Article 9-A returns.** In another new FAQ, the Department has announced that it will not impose underestimated tax penalties for the tax periods beginning on or after January 1, 2015 and before January 1, 2016; in other words, for the first returns filed under the corporate tax reform regime. Any underestimated tax penalties already paid for such year will be treated as tax overpayments, and the Department will notify corporations of how it is applying the overpayments and how corporations may request any resulting refund. Other penalties, including for the substantial understatement of tax, may still be imposed.

- **Proper treatment of net operating losses incurred prior to 2015.** A new FAQ makes clear that unused NOLs incurred for tax years beginning prior to January 1, 2015, must be converted into a prior net operating loss conversion subtraction on Form CT-3.3, *Prior Net Operating Loss Conversion (PNOLC) Subtraction*, and must be reported on Part 3, line 16 of Form CT-3 or CT-3-A. Corporations that have incorrectly reported the pre-2015 NOL conversion amounts on Part 3, line 18, *NOL deduction*, must file amended returns and include Form CT-3.3 to avoid a denial of the deduction and the possible issuance of a notice of deficiency.

- **Updates to 2015 Corporate Tax Returns for holders of qualified financial instruments.** Principally affecting corporations that hold financial instruments marked to market under IRC §§ 475 or 1256, the forms have been corrected in the following respects: (i) loans secured by real property, even if marked to market, cannot qualify as Qualified Financial Instruments ("QFIs") (and thus are ineligible for the fixed 8% fixed percentage sourcing election); and (ii) where a corporation has more than one type of financial instrument being reported in the catch-all category of "other" financial instruments, only those types of instruments that are actually marked to market will qualify as QFIs.

  These corrections do not appear in the published Article 9-A tax forms or instructions. If a corporate taxpayer has already filed its 2015 return inconsistent with these changes, the Department requires that the corporation file an amended return consistent with these changes. The Department also reminds partnerships with corporate partners to check for website updates that may impact corporate tax forms to be used by the partners, which most likely would relate to issues of economic nexus and sourcing for corporate partners.

Tax Appeals Tribunal Upholds Denial of Sales Tax Credit for Hotel Meals

By Hollis L. Hyans

The New York State Tax Appeals Tribunal has upheld the decision of an Administrative Law Judge that a Manhattan hotel may not claim a sales tax credit for its costs to purchase continental breakfasts made available to hotel guests as part of their room charges. *Matters of Washington Square Hotel LLC and Daniel Paul*, DTA Nos. 825405, 825505, & 825821 (N.Y.S. Tax App. Trib., July 19, 2016).

Facts and Issues. During December 1, 2007, through May 31, 2010, the years in issue, the Washington Square Hotel LLC (the "Hotel") owned and operated a

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hotel on Waverly Place in New York City. Its brochures indicated that the room rates include a continental breakfast and that a restaurant is also on the premises. As part of its contracts with travel companies, which also advertised that the room rates included a continental breakfast, the hotel provided rates for meals described as American breakfast for $15, lunch for $25, and dinner for $40. No rates for continental breakfasts were given. No separate charge for the continental breakfasts appeared on guests' bills, and guests did not have the option to decline the breakfast and obtain a lower rate. The Hotel purchased the continental breakfasts from a restaurant operated by a related entity. It paid sales tax on the purchases and then claimed a sales tax credit for the tax it paid on the purchases.

Prior to 2002, the Hotel had not paid sales tax when purchasing the breakfasts, but had provided the seller with a resale certificate. During an audit of the restaurant in 2002, the Department's auditor indicated that the restaurant should charge sales tax, although it was unclear from the record whether the auditor also expressly advised the Hotel to claim a credit for the sales tax. The Hotel was later audited for the period September 1, 2003, through May 31, 2006, periods during which it had also claimed the sales tax credit, and no issues appeared to have been raised with this treatment during the audit.

On audit of the years in issue, the Department denied the credit, resulting in additional tax of approximately $300,000. The hotel also filed an application for a refund of approximately $22,000 on the same resale theory for the period December 1, 2011, to February 29, 2012; this refund was similarly denied by the Department.

ALJ Decision. The ALJ upheld the Department's denial of the credit and refund. She found that although Tax Law § 1101(b)(4)(i), commonly known as the "sale for resale" exclusion, allows an exclusion from tax for amounts paid to purchase tangible property for resale, the exclusion only applies when the property is resold "as such" or as a component part of other tangible personal property, or is used in performing certain specified services. Since the service of providing hotel rooms for occupancy is not included within the specified qualifying services, the sale of continental breakfasts as part of the service of providing hotel rooms does not fall within the sale for resale exclusion in Tax Law § 1101(b)(4)(i)(B). She also found that the record contained no evidence that a continental breakfast was actually sold to guests or that the price for each breakfast was separately stated. The ALJ relied primarily on *Matter of Helmsley Enterprises., Inc.*, (N.Y.S. Tax App. Trib., June 20, 1991), *aff'd*, 187 A.D.2d 64 (3d Dep't 1993), *lv denied*, 81 N.Y.2d 710 (1993), in which the Tax Appeals Tribunal found that a hotel's purchase of furniture, guest room supplies, and in-room amenities were not considered purchases for resale because the items were furnished to guests not as resales of tangible personal property, but as a component part of an "overall package of services." The ALJ also rejected the hotel's argument that the Department should be estopped from changing its position from that taken in earlier audits.

"[P]roperty used in providing a hotel service is not resold as such to guests, but is inseparably connected to the provision of the service."

Tribunal Decision. The Tribunal affirmed the ALJ, relying on the Department's regulation, 20 NYCRR § 527.9(h)(1)(iii), which provides that "the entire charge" for a hotel room "is subject to tax as rent for the occupancy," and also on the decision in *Helmsley*, 187 A.D.2d at 69, for the proposition that "property used in providing a hotel service is not resold as such to guests, but is inseparably connected to the provision of the service." The Tribunal rejected the Hotel's argument argued that the breakfasts, which were not provided in guest rooms, were substantively different from the items in *Helmsley*, finding that the breakfasts were an "amenity incidental to" the provision of services to the guests.

The Tribunal also rejected the Hotel's argument that the Department should be estopped from denying the credit since it accepted the same credit in an earlier audit. It found that "a taxpayer attempting to invoke the doctrine of estoppel against the State has a steep hill to climb," and that the Hotel had failed to establish the kind of "exceptional facts" that would require estoppel to avoid "a manifest injustice." While the records did show that the Department acquiesced to the Hotel's credit claims during the audit of earlier years, there was no evidence that the Department had affirmatively advised the Hotel to claim the credit.

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Additional Insights

After the decision in *Helmsley*, it would seem exceedingly difficult for a hotel to establish that tangible property provided to guests as part of overnight accommodations qualify for the resale exemption when they are initially purchased by the hotel. The Appellate Division in *Helmsley* upheld the Tribunal's conclusion that purchase of items such as guest room furniture, furnishings, and guest consumables "were not sales of tangible personal property for purposes of resale *as such* and were subject to sales tax." 187 A.D.2d at 68 (emphasis in original). The Appellate Division found a distinction between the property provided in Helmsley and the holding in "container cases" such as *Matter of Burger King v. State Tax Commission*, 51 N.Y.2d 614 (1980), where purchases of food wrappers were held to be "resold as such" since the wrappers retained their separate identity when used as containers for food and drinks sold at Burger King restaurants.

With regard to estoppel, as the Tribunal acknowledged, this is a difficult argument for a taxpayer to sustain. The elements of estoppel are generally that a representation was made, that a taxpayer was entitled to rely on that representation, that the taxpayer did in fact so rely, and that such reliance was reasonable under the facts and circumstances. *Matter of Harry's Exxon Serv. Station*, DTA No. 801193 (N.Y.S. Tax App. Trib., Dec. 6, 1988). In that case, a taxpayer received a letter from the Department stating that an audit was complete and no tax was owed, and in reliance on that letter, the taxpayer's accountant destroyed the relevant records, leaving the taxpayer unable to defend against an assessment. In the absence of such extraordinary circumstances, including clear proof of written advice, and conduct taken in reliance on that advice to a taxpayer's detriment, estoppel will not likely be imposed against a taxing authority.

INSIGHTS IN BRIEF

Personal Income Tax Deficiency Upheld Against Nonfiler

In *Matter of Michael C. Schrenke*l, DTA No. 826172 (N.Y.S. Div. of Tax App., July 21, 2016), a New York State Administrative Law Judge upheld an assessment of personal income tax against an individual who had failed to filed New York State personal income tax returns for 2006, 2007, and 2008. Relying primarily upon information obtained from the IRS, the Department issued notices of deficiency, and agreed to certain adjustments after reviewing records, but declined to allow additional claimed itemized deductions for mortgage interest and real property taxes. The ALJ found that the individual had failed to sufficiently demonstrate payment of interest and property taxes, noting that the record actually showed that the property had been foreclosed upon, which if anything indicated that the mortgage payments, which would have included the interest, and tax payments had actually not been made.

Tribunal Holds That Individual Did Not Prove a Change of Domicile From New York City, Where His Wife Resided, to Florida

The New York State Tax Appeals Tribunal held that an individual failed to establish a change in his domicile from New York City to Key Biscayne, Florida, and therefore was taxable as a New York State and City resident. *Matter of Thomas Campaniell*o, DTA No. 825354 (N.Y.S. Tax App. Trib., July 21, 2016). The Tribunal found that application of the objective criteria regarding domicile indicated that the taxpayer did not prove by clear and convincing evidence that he changed his domicile. Among the indicators of his having kept his New York City domicile were that he retained his historical home in the City, in which his wife of 51 years continued to reside and which he used at least 171 days during the year, and that he retained substantial business ties to the City. The fact that he had a Florida apartment for many years and spent more time in Florida than in New York City was outweighed by his many New York City ties.

Authorized Combative Sports Tax Imposed Effective September 1, 2016

Effective September 1, 2016, the New York State "boxing and wrestling exhibitions tax" has been renamed the "authorized combative sports tax" and has been expanded to apply to the newly authorized sports of kick boxing, single discipline martial arts and mixed martial arts. Promotors of amateur or professional authorized combative sports events held in the State must report and pay the authorized combative sports tax at the rate of 8.5% of gross receipts from ticket sales plus 3% of gross receipts from broadcasting rights and from digital streaming over the internet (maximum $50,000 of tax due per event). The tax rates on boxing, sparring and wrestling in the State continue at the rate of 3% of gross receipts from ticket sales (maximum $50,000 per event) and 3% of gross receipts from broadcast rights (each at a maximum of $50,000 per event). The Tax Law has also been clarified that admission charges to any authorized combative sports event taxed in the State is not subject to New York State and local sales taxes. Ch. 32, Laws of 2016; *Authorized Combative Sports Tax*, Technical Memorandum, TSB-M-16(6)M, (8)S (N.Y.S. Dep't of Taxation & Fin., Aug. 18, 2016).

New Sales Tax Exemption for Feminine Hygiene Products

Effective September 1, 2016, sales of feminine hygiene products (including sanitary napkins and tampons) are exempt from New York State and local sales tax. The legislation was enacted after the commencement of a lawsuit by five women seeking class action status who claimed, among other things, that the imposition of sales tax on such products violated their equal protection rights under the U.S. and New York State Constitutions. Ch. 99, Laws of 2016; *Sales and Use Tax Exemption for Feminine Hygiene Products*, Technical Memorandum, TSB-M-16(6)S (N.Y.S. Dep't of Taxation & Fin., Aug. 1, 2016); *Margo Seibert, et al. v. New York State Dep't of Taxation & Fin., et al.*, (Sup. Ct. N.Y. Cnty., Mar. 3, 2016).

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