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MoFo New York Tax Insights

Appellate Division Invalidates Retroactive Changes to New York Empire Zones Tax Credit Program

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By Irwin M. Slomka

In a decision that could have important implications for retroactive tax legislation in New York, the Appellate Division, Fourth Department, has held that 2009 legislative amendments to the New York Empire Zones Program authorizing the retroactive denial of tax credits violated the taxpayer's due process rights and were therefore invalid. *James Square Associates LP, et al. v. Dennis Mullen, Commissioner, N.Y.S. Dep't of Economic Development and Jamie Woodward, Commissioner, N.Y.S. Dep't of Taxation & Fin.*, 2011 NY Slip Op. 08423, CA 11-00675 (4th Dep't, Nov. 18, 2011).

Background. **The New York State Empire Zones Program was enacted in 1986 to provide benefits to taxpayers for developing new businesses or expanding existing businesses**

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within economically impoverished areas designated as "Empire Zones." The program provided several tax credits, including credits for investment and jobs creation, some of which are available for carryover. Qualifying businesses were required to be certified by Empire State Development, and had to receive a Certificate of Eligibility before claiming any Empire Zone ("EZ") credits. Although the program expired on June 30, 2010, certain qualifying businesses retained eligibility for benefits even after the expiration date.

In April 2009, in an effort to close perceived loopholes, the law was amended to tighten the eligibility criteria for certification. Ch. 57, Laws of 2009. Under the amendments, EZ certifications could be revoked if businesses did not meet the new eligibility criteria. One important change was to curb a practice in which new jobs were not truly created, but were simply transferred from an existing business enterprise to a newly-formed related business enterprise. The amendments also added a cost-benefit criterion for continued eligibility. By its terms the law was to "take effect immediately," but the Tax Law was specifically amended to prohibit the carryover of EZ tax credits for tax years beginning on or after January 1, 2008, unless the business obtained an "EZ retention certificate" from Empire State Development, signifying that the new eligibility requirements were met.

Shortly after the 2009 amendments were signed into law, the New York State Department of Taxation and Finance issued a Memorandum requiring that businesses that had previously filed a tax return for 2008 claiming a new or carryover EZ tax credit file an amended return, with a retention certificate attached, or else the credit would not be allowed. *Legislative Changes to the Empire Zones Program*, TSB-M-09(5)C and -09(4)I (N.Y.S. Dep't of Taxation & Fin., Apr. 15, 2009).

Declaratory Judgment Action. The taxpayer plaintiffs in *James Square* are businesses that previously were certified to receive Empire Zone tax benefits, but whose certifications were later retroactively revoked back to January 1, 2008 pursuant to the 2009 legislative changes. It was undisputed that the businesses did not meet the revised eligibility criteria and that their certifications were properly revoked under the amended statute. However, the taxpayers brought a declaratory judgment action in Onondaga County to challenge the retroactive decertification, under the revised eligibility criteria, back to January 1, 2008.

In June 2010, a New York Supreme Court judge initially held that the Legislature did not intend to apply the changes retroactively. Following the enactment of "clarifying" legislation in August 2010 regarding the Legislature's intent to make the changes retroactive — enacted in response to the judge's earlier order — the judge issued a second order (in February 2011), holding that the retroactive decertifications constituted an unconstitutional taking of the taxpayers' property and could only be applied prospectively. The State appealed.

THE COURT NOTED THAT THE STATE OFFERED NO JUSTIFICATION FOR RETROACTIVE APPLICATION APART FROM THE ADDITIONAL REVENUE IT WOULD REALIZE.

Appellate Division Decision. On appeal, the Fourth Department agreed with the State that the Legislature's intent was indeed to make the revocations retroactive to January 1, 2008. However, the court held that, notwithstanding that intent, retroactive application of the 2009 amendments violated the taxpayers' due process rights and the amendments were therefore null and void.

The court began by identifying the three criteria in New York for determining whether retroactive tax legislation withstands constitutional scrutiny. In *Matter of Replan Dev. v. Dep't. of Hous. Preserv.* 70 N.Y.2d 451 (1987), the Court of Appeals, applying a "balancing of the equities" analysis, considered three factors: First, was the taxpayer forewarned of the legislative change so that reliance on the prior law was unreasonable? Second, was the retroactive period excessive? Third, did the retroactive application serve an important public purpose?

The Fourth Department concluded that these factors all militated in favor of the taxpayers. The court felt that one of the factors — whether the 16 month retroactive period was excessive — could only be evaluated in light of the other two factors. The court found that the taxpayers had no warning that the certification criteria was going to change prior to the April 2009 amendments. The court considered it significant that the taxpayers "were induced to conduct their businesses in a particular way in specified disadvantaged areas in reliance upon the availability of Empire Zones' tax credits." As for whether retroactive revocation served a legitimate public purpose, the court noted that the State offered no justification for retroactive application apart from the additional revenue it would realize, concluding:

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> "the apparent absence of a persuasive reason for retroactivity, with its potentially harsh effects, offends constitutional limits, especially when the tax [credit eliminated] is one which might exert significant influence on . . . business transactions." (citation omitted).

Accordingly, the Fourth Department concluded that the 2009 legislative amendments could only apply prospectively, and not retroactively to January 1, 2008.

Additional Insights. Under U.S. Supreme Court precedent, it is usually difficult to invalidate retroactive tax legislation on Due Process Clause grounds. *See*, *e.g.*, *United States v. Carlton*, 512 U.S. 26 (1984) (which upheld retroactive tax legislation based on a showing of a "rational legislative purpose"). In a much-cited concurring opinion, however, Justice O'Connor held that "[a] period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions." The New York Court of Appeals has adopted its own "balancing of the equities" analysis, set out in the *Replan* decision (discussed above) and earlier in *Clarendon v. State Tax Commission*, 43 N.Y.2d 933 (1978) (holding that State tax legislation enacted in 1973, but made retroactive to the taxpayer's 1972 tax liability, violated due process).

Retroactive tax legislation, if for a short period, will generally be upheld by the New York courts. The 16-month period of retroactivity in *James Square*, however, was certainly longer than most retroactive enactments. Rarely a year goes by without one piece of tax legislation being enacted mid-year, retroactive to the beginning of the year. This decision would not appear to impact those types of enactments.

The Fourth Department's emphasis on the EZ tax credits as having "induced" the taxpayers to conduct their business in a particular way suggests the court considered there to be an implicit "contract" between the parties that subsequent legislation could not legally impair. Unlike many other instances of retroactive legislation, such as retroactive tax rate increases, where it is often unclear whether the taxpayer would have done anything differently had it known of the changes, in *James Square* there was no question that the taxpayers altered their behavior and took actions in direct reliance on the availability of the EZ tax benefits. Coupled with the lengthy period of retroactivity, and the prevailing New York precedent, the decision is not surprising. Although it may be appealed, and for now is binding precedent only in the Fourth Department (in western New York), it demonstrates that the Legislature does not have unbridled authority to enact retroactive tax legislation.

New York Residents Leave Their Statutory Residence Behind

By Hollis L. Hyans

In the latest development concerning residency issues in New York, the New York State Department of Taxation and Finance has ruled that the petitioners did not maintain a permanent place of abode in New York after they moved to Connecticut and had only restricted access to their New York City apartment. *Advisory Opinion*, TSB-A-11(9)I (N.Y.S. Dep't of Taxation & Fin., Nov. 8, 2011).

Facts. The petitioners in this request moved out of their New York City apartment on May 14, 2010, and changed their domicile from New York to Connecticut at that time. All of their personal items were moved to Connecticut, and their vehicle registrations, driver's licenses, voter registrations, and bank accounts were all changed to Connecticut. However, they continued to own their New York City apartment, and continued to pay for electrical utilities as part of common charges, until they sold it in 2011.

After the apartment was vacated, extensive renovations were done to prepare it for sale. The work included substantial demolition, removal of walls, relocation of built-in office furniture, replacement of floors, rewiring, and repainting of all walls and ceilings. Before the apartment was listed for sale, new "staging" furniture, carpets, art work, linens, decorative accessories and personal effects were either purchased, borrowed, or provided by the real estate agent to increase the likelihood of sale. After the apartment was sold, the staging items were either returned to those who loaned them, sold, or donated to charity.

The listing agreement with the real estate agent required that the petitioners would not live in the apartment during the sale process, in order to keep the apartment in good condition and allow it to be shown at a moment's notice, and the petitioners turned over their keys to the real estate agent. A signed contract for the sale of the apartment was completed on December 6, 2010, and a closing held on February 23, 2011. One petitioner returned to the apartment one week prior to the closing to remove the staged furniture.

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Statutory Residence Ruling

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Ruling. An individual is treated as a full-year resident, required to pay New York State and City personal income tax on all income from all sources, if he or she is domiciled in New York City, or maintains a permanent place of abode and spends more than 183 days in the State and City. Tax Law § 605(b)(1). The Department assumed, for purposes of this Advisory Opinion, that the petitioners had changed their domicile from New York to Connecticut on May 14, 2010. Therefore, the question for resolution was whether one of the petitioners, who had spent more than 183 days in New York during 2010, had maintained a permanent place of abode in the State.

IT IS DIFFICULT TO SEE HOW AN APARTMENT THAT ONE IS PROHIBITED FROM ENTERING, AND TO WHICH ONE DOES NOT HAVE KEYS, CAN BE ONE'S PERMANENT PLACE OF ABODE.

The Department concluded that the apartment was not a permanent place of abode after May 14, 2010. The petitioners were required to turn over all keys, remove their personal possessions, and agree not to live in the apartment during the sale process. Although they did pay for maintenance, they were "contractually prohibited from entering the apartment" and thus did not have unfettered use of it. Therefore, the Department found that the petitioner who spent more than 183 days in New York was not a resident.

Additional Insights. While this decision seems to correctly interpret the statute–since it is difficult to see how an apartment that one is prohibited from entering, and to which one does not have keys, can be one's permanent place of abode–it is likely to still leave many open questions.

In its ruling, the Department distinguished the facts from those in *Matter of Barker*, DTA No. 822324 (N.Y.S. Tax App. Trib. Jan. 13, 2011, and June 23, 2011) (covered in *New York Tax Insights* February 2011 and May 2011 issues), in which the Tax Appeals Tribunal concluded that a vacation home was a permanent place of abode, despite the fact that it was used only very sporadically by the owners and primarily used by relatives, and in which the Tribunal, quoting earlier decisions, held that "'[t]here was no requirement that the petitioner actually dwell in the abode, but simply that he maintain it.'" The Department also distinguished *Matter of Gaied*, DTA No. 821727 (N.Y.S. Tax App. Trib. June 16, 2011)*, appeal filed*, Oct. 14, 2011 (covered in the July 2011 issue of *New York Tax Insights*), in which the Tribunal held that an individual's Staten Island home occupied by his elderly parents remained a permanent place of abode, finding that he continued to own the house and paid expenses for its upkeep, and noting that the individuals' claim that he did not have unfettered access was not credible.

However, it is difficult to understand the fine distinctions being made in these decisions, since the connection of the taxpayers to the State in *Barker* and *Gaeid* also seems quite slim; or to understand the policy reasons that might result in encouraging individuals to aggressively sever their ties with New York, since the consequences of a determination of residency can have a substantial effect on the tax burden borne by individuals with only remote connections to New York.

On December 15, 2011, the Department issued a Tax Bulletin to "explain … what is meant by the term *permanent place of abode*." TB-IT-690 (N.Y.S. Dep't of Taxation & Fin., Dec. 15, 2011). While some guidance is provided, particularly for situations involving corporate apartments and college students, the rules for other situations are still unclear. For example, the Tax Bulletin states that, even if the individual does not own or lease the living space, making "contributions to the household, in the form of money, services or other contributions" will lead to a conclusion that the individual will be considered to be maintaining the abode, as long as the individual also has unfettered access to the space.

Tribunal Holds No Change in Domicile for Taxpayer Relocated Abroad

By Kara M. Kraman

The New York State Tax Appeals Tribunal has held that a taxpayer failed to prove a change in domicile to the United Kingdom, where the taxpayer had relocated for work. The Tribunal, affirming an Administrative Law Judge decision, held that although the taxpayer eventually did change her domicile to the UK, she had not yet done so during the years in question. *Matter of Eileen Taylor*, DTA No. 822824 (N.Y.S. Tax. App. Trib., Dec. 8, 2011).

Eileen Taylor filed a petition for redetermination of a deficiency of New York State and New York City personal income taxes for the years 2002 through 2004 ("years in issue"). Ms. Taylor, a resident of New York, first moved to London in 1999 as part of a three-year assignment by her employer, Deutsche Bank. At the

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end of the three-year assignment, it was contemplated by both her and her employer that she would return to New York and Ms. Taylor did not contest that she was domiciled in New York prior to 2002. However, when the initial three-year assignment came to an end in 2002, Ms. Taylor was promoted to the position of chief operating officer of the bank's institutional client group, and she and her employer agreed to extend her employment in London through August 2003. In August 2003, Ms. Taylor's employment contract was extended for an additional year through August 2004 ("2003 extension"), and in August 2004, Ms. Taylor's employment contract was again extended for an additional year through August 2005 ("2004 extension").

MS. TAYLOR'S PRESENCE IN LONDON WAS CONTINGENT ON HER EMPLOYER'S DESIRE TO KEEP HER THERE, . . . MS. TAYLOR'S EMPLOYMENT CONTRACT SPECIFICALLY DESIGNATED HER "HOME LOCATION" AS IN NEW YORK AND . . . HER PENSION, RETIREMENT, HEALTH INSURANCE, AND OTHER BENEFITS ALL REMAINED WITH THE HOME LOCATION.

Ms. Taylor's employment contract, and her subsequent extensions, specified Ms. Taylor's "home location" for employment purposes as being in New York and her "host location" as being in London. Under the terms of the contract and its extensions, her social security, pension participation, health insurance, and other benefit plans all remained with or were governed by the applicable rules of New York, and the home location reserved the right to terminate her assignment with the host location at any time and reassign her back to New York or elsewhere.

Ms. Taylor's original employment contract also provided that her employer would lease her an apartment in London in the employer's name, and that Ms. Taylor would receive a housing allowance equal to 67% of the rent for such property. Pursuant to the terms of the 2003 extension, Ms. Taylor's housing allowance was reduced to 35% upon her purchase of a house in London in March 2003. The 2004 Extension eliminated the reimbursement for housing expenses entirely. Ms. Taylor made extensive renovations to her London residence, which was worth significantly more than her two New York residences combined. Nevertheless, she continued to own two residences in New York State, which she claimed were retained for investment purposes.

In August 2004, Ms. Taylor applied for citizenship in the UK after satisfying the five-year physical presence requirement mandated by UK law. She was granted citizenship in 2005. During the hearing before the ALJ, Ms. Taylor stated that she started looking for a residence to purchase in London in 2002, and that as of 2002, she had come to enjoy life in the UK and had decided to permanently relocate to the UK because "she loved it there." Ms. Taylor claimed she was no longer a New York domiciliary beginning in 2002.

The regulations under the personal income tax define domicile as "the place which an individual intends to be such individual's permanent new home." 20 NYCRR § 105.20(d)(1). The regulations further provide that: "A domicile, once established continues until the individual in question moves to a new location with the bona fide intention of making such individual's fixed and permanent home there." 20 NYCRR § 105.20(d)(2). The regulations also provide that a United States citizen who moves abroad because of an assignment by such citizen's employer "does not lose such citizen's New York State domicile unless it is clearly shown that such citizen intends to remain abroad permanently." 20 NYCRR § 105.20(d)(3). Under New York law, the party alleging a change in domicile has the burden of proving such a change by clear and convincing evidence.

Tribunal Decision. The Tax Appeals Tribunal, affirming the ALJ's decision, found that the record supported the ALJ's conclusion that before and during the years at issue, Ms. Taylor's presence in London was initiated by the demands of her career, and that she failed to prove by clear and convincing evidence that she acquired a new domicile in London during 2002, 2003, or 2004. The Tribunal noted that Ms. Taylor's presence in London was contingent on her employer's desire to keep her there, that Ms. Taylor's employment contract specifically designated her "home location" as in New York and that her pension, retirement, health insurance, and other benefits all remained with the home location. The Tribunal also considered Ms. Taylor's receipt of a housing allowance in London up until the second half of 2004 to be inconsistent with a permanent move and a change of domicile. While the Tribunal conceded that Ms. Taylor developed a personal life and ties to London over the course of stay that caused her to eventually adopt London as her domicile, it held that the record did not show such change occurred until after 2004.

Additional Insights. This case demonstrates the difficulties in proving a change of domicile where the precipitating event causing the move is an employment assignment. Even

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Ms. Taylor's application for citizenship in the United Kingdom in 2004 and the termination of her housing allowance in the 2004 extension were not enough to overcome the arguably boilerplate language in her employment contract, which the Tribunal seemed to rely on in holding that she did not change her domicile during that time. Under the circumstances of this case, short of selling her New York residences, it is hard to see what Ms. Taylor could have done to satisfy the Tribunal that she had abandoned her New York domicile.

Appeals Court Finds NYC Hotel Tax Changes Violated the State Constitution

By Hollis L. Hyans

Reversing the trial court, the Appellate Division, First Department, has held unconstitutional the 2009 amendments to the New York City Hotel Room Occupancy Tax ("hotel tax"), which applied the tax to the entire amount paid by a hotel guest for a hotel room, including fees and other amounts paid to a new defined category of entities, "room remarketers." *Expedia, Inc., et al. v. The City of New York Dep't of Finance*, 2011 NY Slip Op. 08648 (1st Dep't, Nov. 29, 2011).

The hotel tax is a tax imposed on the occupancy of each hotel room in New York City, at the rate of 5.78%. Until 2009, the tax was based on the price paid to the hotel for the room, and required only a hotel "operator" to collect and remit the tax. An operator is defined as anyone "operating a hotel in the city of New York." Admin. Code § 11-2501(2). Effective September 1, 2009, the hotel tax was amended to expand the definition of those required to collect and remit tax to include a "room remarketer," defined as "[a]ny person, excluding the operator, having any right, accessibility or authority, through an internet transaction or any other means whatsoever, to offer, reserve, book arrange for, remarket …or facilitate the transfer of rooms… " Admin. Code § 11-2501(12) (as effective Sept. 1, 2009 through Sept. 1, 2010). It also imposed the tax on the entire amount paid by a consumer, adding new defined terms: "net rent" (the amount received by a hotel operator from a room remarketer) and "additional rent" (the excess amount, over the net rent, received by the room remarketer). Admin. Code §§ 11-2501(13) and (14). Room remarketers were required by the new statute to inform hotel room occupants of the amounts of tax attributable to the net rent and the additional rent, which must be separately stated, and to collect tax on the net rent as well as the additional rent.

A number of third-party travel intermediaries, including Expedia, Travelocity.com and Priceline.com, filed suit in New York Supreme Court, claiming that the City had exceeded the authority provided to it by State law, that the expansion of the City's hotel tax base requires legislative action by the State, and the new law was not consistent with existing statutes.

Although the trial judge rejected the challenges, finding that the State had delegated the power to impose tax in broad enabling legislation, the Appellate Division reversed. It found that the "plain language of the enabling legislation did not clearly and unambiguously provide the City with broad taxation powers," but only permitted the City "to impose the tax on 'hotel occupants.'" Invoking what it called the well-established rule that a tax imposition statute must be narrowly construed, with all doubts resolved in favor of the taxpayer, the Appellate Division held that the plain meaning of the statute did not include imposition of tax on the service fees charged by the travel intermediaries, and that action by the State Legislature–which actually did occur in 2010–was necessary in order to impose a tax on the service fees.

Additional Insights. This decision is another step in the continuing nationwide litigation over the imposition of municipal hotel occupancy taxes on hotel room charges paid by consumers through travel services such as Expedia, Priceline, and Travelocity. On December 29, the City filed an appeal to the Court of Appeals, New York's highest court, so the last word may not yet have been heard.

While it is not often that a City statute is invalidated as exceeding the scope of State legislation, the City's power to impose taxation is limited, and extends no further than the power granted to it by the State enabling legislation. However, its impact in the area of hotel occupancy tax may be limited, since, as the court noted, new legislation was enacted by New York State, effective September 1, 2010, expanding the definitions of the class of persons who are required to collect tax and the definition of rent, and also modifying the definitions of those terms in the City's hotel tax. *See Amendments Affecting the Application of Sales Tax to Rent Received for Hotel Occupancy by Room Remarketers*, TSB-M-10(10)S (N.Y.S. Dep't of Taxation & Fin., Aug. 13, 2010); N.Y.C. Finance Mem. No. 10-3 (N.Y.C. Dep't of Fin., Sept. 1, 2010).

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Assignment of a Lease Held to Constitute a Bulk Sale

By Hollis L. Hyans

The New York State Tax Appeals Tribunal has upheld the determination of an Administrative Law Judge that the transfer of a lease agreement for a diner was a transfer of a business asset qualifying as a bulk sale and, since no timely notice of the sale was provided, the new lessee became liable for sales and use taxes owed by the seller, to the extent of the greater of the purchase price or the fair market value of the business assets transferred. *Matter of Suffolk Center Corp.*, DTA No. 822414 (N.Y.S. Tax App. Trib., Nov. 23, 2011). The Tribunal also held that the use by the Department of Taxation and Finance of studies prepared by the Risk Management Association was a reasonable method of determining the fair market value of the transferred assets.

WHILE THE TRIBUNAL FOUND THAT THE ASSIGNMENT OF THE LEASE ALONE WOULD BE SUFFICIENT…THE RECORD SHOWED THAT ASSETS, INCLUDING LIQUOR STOCK AND OTHER INVENTORY, WERE TRANSFERRED, AND SO SUFFOLK WAS HELD TO BE A PURCHASER IN A BULK SALE TRANSACTION.

The case involved the February 2007 transfer of a lease agreement for a property used as a diner in Centereach, New York, from 2101 Diner Corp. to Suffolk Center Corp. ("Suffolk"). The lease included the rental and use of the diner, business fixtures, and equipment, which were stated to be owned by the landlord. The transfer agreement required Suffolk, the transferee, to execute a promissory note to 2101 Diner Corp. for $15,000. No other consideration was specified.

No bulk sales notification of the expected transfer was filed with the Department prior to the sale. During the course of a sales and use tax audit of 2101 Diner Corp. conducted in 2007, the auditor learned that the business had been purchased, and requested information on the sale and a completed bulk sale notification form. No response was initially received to this request, or to a follow-up request. Several months later, after Suffolk's attorney was informed by the Department that it considered the lease assignment to qualify as a bulk sale, and nearly five months after the sale, a bulk sale notification was submitted, reciting consideration of $15,000 and stating that the only asset transferred was the lease, identified as intangible property. However, the lease agreement, a copy of which the Department eventually obtained by the time of the Conciliation Conference in 2008, included an addition to the description of the leased property for "the fixtures and equipment" set forth in an attached Schedule D, which was a handwritten list of fixtures and equipment.

The Department issued a Notice of Determination to Suffolk, the bulk sale purchaser, seeking additional sales and use taxes due from 2101 Diner Corp. of $245,095. In order to calculate the fair market value of the business assets of 2101 Diner Corp.—to determine the upper limit on Suffolk's liability–the Department relied upon information from the *2007-2008 Annual Statement Studies – Financial Ratio Benchmarks* published by the Risk Management Association ("RMA"), described as a "not-for-profit, member-driven professional organization." The opinion recites various different methods used by the Department to determine fair market value, all relying on various RMA ratios. One estimate determined fair market value to be more then $5.3 million, another arrived at approximately $832,000, a third came in at $287,000, and a fourth at $691,000. Finally, a sales tax technician in the Department's Bulk Sales Unit independently calculated the estimated value at approximately $832,000. Since all of the estimates were in excess of the liability assessed, the auditor concluded Suffolk was responsible for the entire amount of the seller's unpaid sales tax deficiency.

Tribunal Decision. The Tribunal affirmed the ALJ, and agreed with the Department. First, the Tribunal relied on the definition of "bulk sale" in 20 NYCRR 537.1(a), which included "any sale, transfer or assignment in bulk of any part or the whole of business assets, other than in the ordinary course of business… " While the Tribunal found that the assignment of the lease alone would be sufficient, citing *Matter of Acres Stor. Co. v. Chu*, 120 A.D.2d 854 (3d Dep't 1986), the record showed that assets, including liquor stock and other inventory, were transferred, and so Suffolk was held to be a purchaser in a bulk sale transaction. Therefore, under Tax Law § 1141(c), since it did not file a timely notice, Suffolk was liable for the seller's unpaid sales tax, to the extent of either the purchase price or the fair market value of the business assets transferred, whichever is greater.

The Tribunal then held that the use of RMA ratios was an acceptable method in determining the value of a business, and that Suffolk failed to meet its burden of producing clear and convincing evidence that the methodology was unreasonable or erroneous. Therefore, Suffolk was found liabile for the entire assessed amount.

Additional Insights. This decision provides an important reminder about the bulk sale notification requirements. Whenever there is a transfer of an ongoing business, even if structured as a

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lease assignment, a careful review needs to be done to determine if the bulk sales rules will govern, since the consequences to the transferee can be significant.

The determination made by the Department of the fair market value is also interesting. Perhaps because Suffolk claimed that the stated consideration of $15,000 should serve as the upper limit for its liability, it does not appear from the decision that the petitioner introduced detailed evidence challenging the Department's various estimates of fair market value, or introduced any studies of its own. Given that the Department's estimates, using different methods all derived from various RMA ratios, varied so widely from approximately $288,000 to more than $5 million, it may have been possible to raise a challenge to the methods of estimation used, perhaps through introduction of an alternative valuation.

Informal Refund Claim Can Satisfy Statute of Limitations

By Kara M. Kraman

A State Administrative Law Judge has held that an informal request for a refund can be enough to satisfy the three year statute of limitations for refunds under certain circumstances. If the informal claim contains certain elements, and is received within the statutory period for filing a claim for refund, the claim for refund may be allowed to be perfected after the statute of limitations has run. *Matter of Charles and Susan Van Ness*, DTA No. 823316 (N.Y.S. Div. of Tax App., Nov. 23, 2011).

In 2005, New York residents Charles and Susan Van Ness recognized capital gain on a sale of real property located in California. The Van Nesses properly reported the capital gain on their 2005 New York State Resident Income Tax return and paid the tax due. In 2008, the California Department of Taxation notified the Van Nesses that they owed California income tax for 2005 on the California gain. The Van Nesses paid the California tax, and then timely filed an amended Resident Income Tax return for 2005 claiming a tax credit, and a refund for the tax they paid to California. The Van Nesses filed their amended return claiming a refund via United States Postal Service first-class mail in January 2009, but the Department never received the return.

In February 2009, the Van Nesses received an assessment from the Department regarding a separate issue involving the underreporting of the Van Nesses' adjusted gross income in 2005 (the "AGI adjustment issue"). The Van Nesses corresponded with the Department between February 2009 and October 2009 regarding the AGI adjustment issue, at which time the assessment was cancelled. Enclosed with the assessment notice regarding the AGI adjustment issue was a Request for Conciliation Conference form. On April 2, 2009, the Van Nesses filed the Request for Conciliation Conference, which included the following statement: "Amended return filed for 2005 indicating an overpayment of refund of $28,739- plus interest please adjust your assesment [sic] accordingly."

WHERE AN INFORMAL CLAIM FOR REFUND HAS A WRITTEN COMPONENT THAT ADEQUATELY APPRISES THE TAXING AUTHORITY THAT A REFUND IS REQUESTED, INDICATES THE TAX YEAR IN QUESTION, AND IS RECEIVED WITHIN THE STATUTORY PERIOD FOR FILING A CLAIM FOR REFUND, IT IS A TIMELY FILED REFUND CLAIM THAT MAY BE PERFECTED AFTER THE STATUTE OF LIMITATIONS HAS RUN.

On June 15, 2009, the Department acknowledged receipt of the Request for Conciliation Conference, but stated that they had no record of an amended tax return having been filed for 2005. In response, the Van Nesses sent a copy of their amended tax return to the Department in September 2009. The Department deemed the amended return they received to have been filed in September 2009, and disallowed the claim for refund because the deadline for claiming a refund for 2005 expired on April 15, 2009, three years after the due date of the 2005 return.

Tax Law § 687 provides that the statute of limitations for filing a claim for refund is three years from the time the return was filed. The burden of proof of showing that the claim for refund is timely is on the taxpayer. As a preliminary matter, the ALJ held that the Van Nesses did not meet their burden of showing that their amended return containing a claim for refund was timely mailed in January 2009. However, the ALJ noted that there are circumstances under which a taxpayer's informal claim for refund made within the three-year limitations period may be treated as a timely refund claim.

Citing several federal cases as well as prior Tax Appeals Tribunal decisions, *e.g.*, *Matter of Battaglia*, DTA No. 817477 (N.Y.S. Tax App. Trib., Apr. 18, 2002), the ALJ stated that where an informal claim for refund has a written component that adequately apprises the taxing authority that a refund is

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Informal Refund Claim

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requested, indicates the tax year in question, and is received within the statutory period for filing a claim for refund, it is a timely filed refund claim that may be perfected after the statute of limitations has run. The ALJ held that the Van Nesses' statement regarding the refund claim in their Request for Conciliation Conference, made while the three-year limitations period was still open, satisfied the elements of an informal refund claim and was timely. That informal refund claim was later perfected in September 2009 when the Van Nesses submitted the amended return after the statute of limitations had expired.

Additional Insights. Although statutes of limitations are widely regarded as being inviolable and not subject to exception, that is not always the case. As discussed above, case law in New York State sometimes provides a limited exception to the hard and fast three-year statute of limitations for filing a claim for refund if an informal request is made within the period of limitations and certain other requirements are met. As we went to press, it was not known whether the Department would appeal the ALJ's decision.

NYC Implements New Audit Policy Disallowing Deductions by Hedge Fund Managers

By Irwin M. Slomka

The New York City Department of Finance has adopted a new a position on audits that could result in additional New York City unincorporated business tax ("UBT") or general corporation tax ("GCT") liabilities for hedge funds managers in New York City.

Most hedge funds are investment partnerships. General partners that manage hedge funds generally receive a management fee, as well as a "carried interest" equal to a specified percentage (e.g., 20%) of realized capital gains. Many hedge fund managers in New York City, in order to avoid subjecting carried interests to the 4% UBT, form two separate legal entities: (i) a management company (a partnership or a corporation) to perform services for the hedge fund in exchange for a management fee; and (ii) a separate partnership entity solely to receive the carried interest. The carried interest received by the separate partnership is generally not subject to UBT because the income is considered to be from exempt investment activity. However, the management fee is subject to either UBT (if the management company is a partnership), or GCT (if the management company is a corporation).

Recently, the Department has informally announced that it will take the position on audit that some of the management company's expenses in these situations are not deductible by the management company, but must be reallocated in part (on an IRC § 482-type theory) to the partnership entity that receives the carried interest. As a result, a portion of the management company's expenses will be disallowed, resulting in an increase in its UBT (or GCT) liability. This represents a significant departure from the Department's long-standing audit policy, and would apply even though the IRS has not made a similar IRC § 482-type adjustment. The new audit policy has not been formally announced in a Statement of Audit Procedure, and we understand that the Department has not yet issued any tax assessments under this new policy.

Using Fulfillment Services in New York Does Not Eliminate Public Law 86-272 Protection

By Open Weaver Banks

In an *Advisory Opinion*, TSB-A-11(10)C (Nov. 1, 2011), the New York State Department of Taxation and Finance has ruled that a foreign (i.e., non-New York) corporation selling tangible personal property to customers in New York State is protected by Public Law 86-272 from the imposition of New York State corporation franchise tax, and does not lose that protection as a result of using third-party fulfillment services located in New York.

The foreign corporation in the Advisory Opinion sells gifts and awards to companies that wish to honor their employees. It has manufacturing and warehousing facilities in North Carolina, where it manufactures certain of the products, and also sells products acquired from third-party vendors, some of whom are located in New York. The foreign corporation uses sales representatives to solicit sales in New York and other states. The representatives' activities in New York were limited to solicitation of orders for sales of tangible personal property, and the orders were sent out of New York for approval.

Delivery of the gifts and awards occurred in one of two ways. If the gifts and awards were manufactured at the foreign corporation's facilities in North Carolina, the foreign corporation shipped the items directly from North Carolina to the employee receiving the gift. If the goods were produced by a third-party vendor, the foreign corporation directed the third-party vendor to ship the gift to the employee. The foreign corporation did not take title to any gift shipped by such a vendor.

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86-272 Protection Applies

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Based upon a review of the foreign corporation's activities, the Department concluded that its activities in New York fell within the scope of Public Law 86-272. Pursuant to Public Law 86-272, a foreign corporation is exempt from income taxation if the only activity of its employees in New York is the solicitation of orders for sales of tangible personal property, which orders are sent out of New York for approval, and, if approved, are filled by shipment or delivery from a point outside New York.

While the statute contains a requirement that the orders for tangible personal property be satisfied by shipment or delivery from a point outside New York, the Department reasoned that the use of a third-party vendor to provide shipping services from within New York did not disqualify the foreign corporation from the Public Law 86-272 exemption because the use of "fulfillment services" is an exempt activity in New York.

Under Tax Law Section 209.2(f), the use of the fulfillment services of a person other than an affiliate, as well as the ownership of property on the premises of the fulfillment service provider in conjunction with such services, does not subject a foreign corporation to New York corporation franchise tax. Fulfillment services are defined as the following services performed by an entity on its premises on behalf of a purchaser: (a) the acceptance of orders electronically or by mail, telephone, telefax, or Internet; (b) responses to consumer correspondence or inquiries electronically or by mail, telephone, telefax, or Internet; (c) billing and collection activities; or (d) the shipment of orders from an inventory of products offered for sale by the purchaser. Tax Law § 208.19. Since the use of a fulfillment service in New York is a protected activity, the Department found that the filling of orders by such services would not disqualify the foreign corporation from Public Law 86-272 protection as long as it is not affiliated with any of the vendors.

Additional Insights. This Advisory Opinion correctly concludes that use of an in-state fulfillment house to ship merchandise should not cause an out-of-state company to forfeit its Public Law 86-272 protection. Any other result would make the fulfillment house exception meaningless. The fact that the foreign company does not take title to some of the products it sells was also not a relevant factor. Other states have raised arguments concerning the lack of title to the goods sold, but they have not been successful. *See Schering-Plough Healthcare Prods. Sales Corp. v. Pennsylvania*, 861 A.2d 259 (Pa. 2004), in which the Pennsylvania Supreme Court held that a related party that solicited sales for its parent was entitled to the protection of Public Law 86-272, even though it never took title to the goods. The court found that a company that solicited sales of products it did not own had no greater nexus than a company soliciting sales of products it owned.

SINCE THE USE OF A FULFILLMENT SERVICE IN NEW YORK IS A PROTECTED ACTIVITY, THE DEPARTMENT FOUND THAT THE FILLING OF ORDERS BY SUCH SERVICES WOULD NOT DISQUALIFY THE FOREIGN CORPORATION FROM PUBLIC LAW 86-272 PROTECTION.

It is worth noting that even if the foreign corporation in the Advisory Opinion had owned the property located at the fulfillment house, the result would have been the same because the fulfillment services exemption extends to the ownership of property on the premises of the fulfillment services provider in conjunction with such services.

While not discussed in the Advisory Opinion, New York also has a provision that an out-of-state company does not become a New York "vendor" responsible for collecting sales and use tax if its only connection with the State is the use of fulfillment services. Tax Law § 1101(b)(8)(v). However, many sellers of tangible goods that qualify for protection from income taxation under Public Law 86-272 would nonetheless be subject to a New York sales and use tax collection obligation on their sales to customers in New York because of the presence of in-state employees soliciting sales. Public Law 86-272 protection for solicitation activities does not extend to state sales and use taxes.

Insights in Brief

State to Require Electronic Filing of PIT Returns Prepared Using Tax Software

The Department of Taxation and Finance has announced that, pursuant to Chapter 61 of the Laws of 2011, it will require that New York State personal income tax ("PIT") returns prepared using tax software be filed electronically. *Electronic Filing and Electronic Payment Mandate for Personal Income Taxpayers*, TSB-M-11(12)I (N.Y.S. Dep't of Taxation & Fin., Dec. 2, 2011). The e-filing requirement applies to returns filed on or after January 1, 2012, which includes the annual PIT return (Form IT-201) for 2011. The Department *may* require that the resulting tax liability be paid electronically. Noncompliance will result in the imposition of a $25 penalty for each failure unless due to reasonable cause and not willful neglect, and no interest will be paid on overpayments until the return is filed electronically. These new provisions will sunset on December 31, 2012.

Appellate Division Again Upholds State's Rule for Imposing Cigarette Taxes on Sales by Indian Reservations

Affirming a decision issued by an Erie County Supreme Court judge in June 2011, and its own earlier decision vacating temporary restraining orders, the Appellate Division has upheld the regulations enacted by the Department of Taxation and Finance to implement the statute imposing tax on sales of cigarettes to non-Indians on Indian reservations. *Seneca Nation of Indians v. State of New York*, 2011 NY Slip Op. 08425 (4th Dep't, Nov. 18, 2011). The court rejected the argument that a Job Impact Statement was required due to the allegedly substantial adverse impact on approximately 3,000 people employed in the Seneca tobacco economy, finding that the negative economic impact of a limited supply of tax-exempt cigarettes is a direct result of the statute, not the implementing rules. The court also rejected the argument that the Department violated the State Administrative Procedure Act by failing to address the "speculative possibility of monopolistic behavior" that might result from the new rules.

WE WISH ALL OF OUR FRIENDS
A VERY HAPPY, HEALTHY,
AND PROSPEROUS NEW YEAR.