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STATE TAX DEPARTMENT RELEASES DRAFT ARTICLE 9-A NEXUS REGULATIONS UNDER CORPORATE TAX REFORM

By Irwin M. Slomka

The New York State Department of Taxation and Finance has released draft amendments to the Article 9-A corporate franchise tax regulations to address significant changes relating to statutory nexus under New York State corporate tax reform legislation enacted in 2014 and 2015. Corporate Tax Reform Draft Regulations, N.Y.S. Dep't of Taxation and Fin. The principal (but not the sole) thrust of the draft amendments is to address the adoption of economic nexus standards that went into effect for tax years beginning on or after January 1, 2015. Corporate tax reform introduced a "bright line" economic nexus standard for taxability for corporations deriving New York receipts of at least $1 million in the taxable year, regardless of whether the corporation itself does business, employs capital, or owns or leases property in the State.

The draft amendments contain several potentially significant proposals:

- A foreign (*i.e.*, non-New York) corporation would be subject to Article 9-A not only in the year it engages in nexus-creating activities–including where it derives at least $1 million in New York receipts–but also would be deemed to be deriving New York receipts in the *subsequent year* from the beginning of that year. A foreign corporation would be deemed to be deriving New York receipts from the date of its first receipt from New York activities, and not from when it reaches the $1 million threshold.
- Economic nexus would be found to exist with respect to corporate general partners of a partnership where the partnership's sole connection to the State is that the partnership derives at least $1 million in New York receipts. This would appear to subject a corporate general partner to tax even where the corporate partner's share of New York receipts is less than $1 million. The draft regulations would also modify the existing nexus rules for corporate *limited* partners.
- Where a limited liability company ("LLC") that is treated as a partnership for income tax purposes has either traditional nexus or economic nexus with New York, *all* corporate members of the LLC would be considered to have nexus. There would be no distinction

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between members based on the member's participation in the business or based on the member's ownership percentage or basis in the LLC. This would be the first time that the regulations address nexus created through a membership interest in an LLC.

- In determining whether the $1 million New York receipts threshold is met for a unitary group of corporations, the New York receipts of a taxpayer's unitary affiliate that meets the more than 50% stock ownership requirement for combination would be included in the computation of the unitary group's New York receipts, even if the affiliate's activities are limited to those described in Public Law 86-272.
- An alien (*i.e.*, non-U.S.) corporation would not be subject to Article 9-A, regardless of whether it has traditional or economic nexus, unless it is treated as a domestic corporation as defined under IRC §7701 or has effectively connected income for the taxable year.

These regulations are in draft form, and have not been formally proposed by the Department under the State Administrative Procedure Act. This is the first time that the Department has posted draft regulation amendments on its website seeking public comment prior to formally proposing those amendments. The Department is inviting comments on the draft amendments by December 3, 2015. Some of the draft provisions could be considered controversial or otherwise requiring clarification, and the Department is expected to receive considerable comments in the coming months.

STIPULATION OF DISCONTINUANCE IN A SALES TAX MATTER COLLATERALLY ESTOPS CHALLENGE TO PERSONAL INCOME TAX ASSESSMENT

By Hollis L. Hyans

The New York State Tax Appeals Tribunal affirmed the decision of an Administrative Law Judge and found that an individual taxpayer was bound by the stipulated result of a sales tax matter involving responsible officer liability, and that the individual was liable for additional personal income tax arising from constructive dividends based upon the findings in the sales tax matter. *Matter of Mohammad and Roosha Javed*, DTA No. 825127 (N.Y.S. Tax App. Trib., Sept. 10, 2015).

Facts and Decision Below. A sales tax audit of a corporation, 492 Fast Food, Inc., for the period September 1, 2004 through February 28, 2007, resulted in an increase in sales of the corporation and an assessment of additional New York sales and use tax due. Petitioner Mohammad Javed, one of the corporation's owners, was assessed for a portion of the tax assessment, plus penalty and interest, as a responsible officer. The personal income tax returns filed by Mr. Javed and his wife were then also audited, and the increased entire net income of the corporation was deemed to be a constructive dividend to the shareholders. Mr. Javed was initially believed to be a 50% shareholder, and therefore 50% of the constructive dividend was treated as additional income to him, resulting in an assessment of personal income tax.

Mr. Javed had filed a petition with the Division of Tax Appeals contesting the responsible officer assessment for sales and use tax. That proceeding was resolved by a stipulation of discontinuance in which tax was reduced from approximately $43,000 to $27,000. Mr. Javed's request for review of the order of discontinuance was denied by the Administrative Law Judge, and his exception in the sales tax case was denied by the Tax Appeals Tribunal. *Matter of Mohammad Javed*, DTA No. 823219 (N.Y.S. Tax App. Trib., Oct. 6, 2011).

Mr. Javed requested a conciliation conference with regard to the assessment of personal income tax, and the amount of tax was reduced, based on two adjustments: one to reflect a proportionate reduction of the deemed constructive dividend based on the reduced amount of sales tax stipulated to be due, and another to reflect the fact that Mr. Javed's interest was only 25%, not 50%. Mr. Javed then petitioned to the Division of Tax Appeals, and the assessment amount was further reduced by allowing expenses related to the deemed increased sales, and by an adjustment of credits.

The ALJ upheld the remaining assessment, finding that the additional corporate income had been agreed to by Mr. Javed, and that he had failed to prove by clear and convincing evidence that the deficiency was erroneous.

Tribunal Decision. On exception, Mr. Javed argued that the additional amounts of tax were erroneous, relying on a letter from one of the corporation's suppliers and on evidence that his financial situation during the period at issue "precludes a finding of additional income." He also argued that he was not bound by the stipulation in the responsible officer sales tax matter.

The Tribunal upheld the ALJ decision, but on a ground never discussed below. First, the Tribunal agreed with Mr. Javed that he was not automatically bound

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by the stipulation in the sales tax matter, any more than an allegedly responsible officer is bound by an agreement made by a corporation in a sales tax matter. However, the Tribunal then went on to determine that the principle of collateral estoppel governs, and that it requires a ruling in favor of the Department.

Under the doctrine of collateral estoppel, a decision in a previous proceeding will be binding if the party seeking estoppel can establish that the party against whom estoppel is sought had a fair opportunity to litigate, that the issues are identical, and that they must necessarily have been decided in the prior proceeding. Once that burden is met, the party opposing collateral estoppel must then establish the absence of a full and fair opportunity to litigate the issue in the prior action.

Here, the Tribunal acknowledged that neither party raised the issue of collateral estoppel before the ALJ, and so the issue was never addressed in the determination. Nonetheless, while noting that there might be a benefit to a remand, the Tribunal found that collateral estoppel clearly applied, and therefore Mr. Javed was barred by its decision upholding the stipulation in the sales tax case. It determined that the issues in the sales tax proceeding and the income tax proceeding are exactly the same; that the parties had a "full and fair opportunity to litigate"; and that the parties were identical (with the exception of Mrs. Javed, who was involved solely as a result of being included in a joint return). The Tribunal also found that the methodology used by the Department was valid and proper.

[While] the Tribunal acknowledged that neither party raised the issue of collateral estoppel before the ALJ . . . the Tribunal found that collateral estoppel clearly applied, and . . . Mr. Javed was barred by its decision upholding the stipulation in the sales tax case.

The Tribunal rejected Mr. Javed's argument that the letter from a supplier established that the assessment was erroneous, noting that the letter itself disavowed the accuracy of the information it contained for purposes of being a complete record of purchases. The Javeds' evidence concerning their personal financial position was also found insufficient, since the Tribunal determined the evidence was only assertions without supporting documents. Therefore, the assessment was upheld.

Additional Insights

The Tribunal decision cites no case in support of its application of the doctrine of collateral estoppel in a case in which neither party raised the issue and the judge below never considered it. That seems an unusual step, since the CPLR, which generally applies to matters in the Division of Tax Appeals, provides in Rule 3211(e) that a claim based on collateral estoppel is waived unless raised in a responsive pleading or in a motion before the pleading is filed. In this case, it does not appear that the Department raised collateral estoppel at any time. The language quoted from the cases relied upon by the Tribunal setting forth the basis for the collateral estoppel doctrine clearly delineates the burden to be carried by the party asserting it, and the response necessary from the party opposing it, which arises only if the initial burden is carried. *See Kuriansky v. Professional Care*, 158 A.D.2d 897 (3d Dep't, 1990) (granting collateral estoppel based on a criminal plea in a prior proceeding); *Matter of Sterling Bancorp*, DTA No. 806271 (N.Y.S. Tax App. Trib., Nov. 18, 1993) (denying the application of collateral estoppel, finding it unclear that either the issues were identical or that there was a full and fair opportunity to litigate). Here, with neither party arguing for the application of collateral estoppel, the Tribunal apparently made its own determination not only to apply the doctrine, but also that all elements had been met and that no further interest would be served by a remand to allow briefing on the issue of application of collateral estoppel.

ALJ FINDS RESPONSIBLE PERSON LIABILITY FOR SALES TAX BUT DECLINES TO UPHOLD FRAUD PENALTIES

By Kara M. Kraman

A New York State Administrative Law Judge has upheld the imposition of personal liability for sales and use tax on an employee of a corporation, but held that the Department's imposition of fraud penalties—on which the Department bore the burden of proof—was not supported by the evidence. *Matter of Peter Sidote*, DTA Nos. 825772, 825899, 825964, and 825965 (N.Y.S. Div. of Tax App., Aug. 13, 2015).

Background. Peter Sidote was an employee of Party Time Beverages ("POP"), a retail and wholesale beverage distributor. Mr. Sidote, POP, and certain other parties were charged by the Suffolk County District Attorney with grand larceny, falsifying business records, and scheming to defraud by knowingly purchasing previously redeemed

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bottles and cans and then redeeming them a second time to third parties. On June 30, 2011, Mr. Sidote entered into a plea agreement with the District Attorney's office and signed a Settlement Agreement and Consent to Forfeiture with Order individually and on behalf of POP. In the plea agreement, Mr. Sidote pled guilty to grand larceny and scheming to defraud, and admitted the factual elements of the charges.

The Department conducted sales tax audits of POP for the periods June 1, 2008 through February 28, 2010 and June 1, 2010 through May 31, 2013. In connection with those audits, the Department issued Notices of Determination to POP and also to Mr. Sidote as a responsible person. Fraud penalties were not asserted in the Notices, but were later asserted by the Department in its Answers to Mr. Sidote's Petitions for Redetermination.

During the periods at issue, Mr. Sidote had signed a resale certificate on behalf of POP as vice president, exercised control over POP's funds, commingled POP's funds with the funds of other business ventures he owned, was the only employee of POP who had undergone the tobacco sales training required by New York State to allow POP to sell cigarettes, was the only POP employee who had a commercial driver's license, and was listed as an officer on POP's balance sheets.

Law. Tax Law § 1133(a) provides that "every person required to collect [the sales] tax imposed by this article shall be personally liable for the tax imposed, collected or required to be collected under this article." A person required to collect the tax is defined to include, among others, every vendor of tangible personal property of services, and corporate officers, directors, and employees who are under a duty to act for such corporation in complying with the requirements of the sales tax. Tax Law § 1131(1).

Tax Law § 1145(a)(2) provides that an additional fraud penalty may be imposed where the failure to pay tax within the time required is due to fraud. "Fraud" is not defined in the Tax Law.

Responsible Person Liability. Although Mr. Sidote claimed that he was not an officer of POP and was not responsible for POP's collection and remittance of sales tax, the ALJ found that Mr. Sidote was a "responsible person" within the meaning of the Tax Law. The ALJ held that the pivotal question in determining whether an individual can be held personally liable for the sales tax is not whether an individual is an officer, but "whether the individual had or could have had sufficient authority and control over the affairs of the corporation." Based on facts in the case, including the fact that Mr. Sidote exercised control over POP's financial affairs, commingled POP's funds with those of his other companies, was the only employee of the company who underwent tobacco sales training, and was the only member of the company who could drive the company truck, the ALJ determined that Mr. Sidote did have the requisite authority and control required to be deemed a "responsible person."

Fraud Penalties. While the ALJ found that Mr. Sidote was a responsible person, she declined to uphold the imposition of fraud penalties. Citing several Tribunal decisions, including *Matter of Sona Appliances*, DTA Nos. 815394 & 815395 (N.Y.S. Tax App. Trib., Mar. 16, 2000), the ALJ held that a finding of fraud requires the Department to provide "clear, definite and unmistakable evidence of every element of fraud, including willful, knowledgeable and intentional wrongful acts or omissions constituting false representation, resulting in deliberate nonpayment or underpayment of taxes due and owing." The ALJ further noted that "mere suspicion of fraud from the surrounding circumstances is not enough."

[A] finding of fraud requires the Department to provide "clear, definite and unmistakable evidence of every element of fraud, including willful, knowledgeable and intentional wrongful acts or omissions constituting false representation, resulting in deliberate nonpayment or underpayment of taxes due and owing."

Accordingly, the ALJ rejected the Department's attempt to assert fraud based on the fact that Mr. Sidote underreported sales tax by over 25%, finding that underreporting alone is not enough to establish fraud. The ALJ also rejected the Department's claim that Mr. Sidote's entire "course of conduct" was indicia of fraud, finding that although Mr. Sidote admitted to criminal conduct in his plea agreement, the conduct he admitted to did not rise to the level of criminal tax evasion.

Additional Insights

When the Department asserts fraud in a tax case, it bears the burden of proof by clear and convincing evidence. This burden is a high one and requires that the Department make more than general allegations of fraud. Instead, the Department must actually demonstrate clear and unmistakable evidence of fraud in relation to nonpayment or underpayment of taxes. The high standard of proof imposed on the Department in matters of fraud makes sense for several reasons, one of

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which is that the assertion of fraud by the Department can have ramifications beyond just enhanced penalties. Although not at issue in this case, an assertion of fraud may suspend the statute of limitations and allow the Department to assess tax long after the normal limitations period has expired.

NYS ALJ DENIES SALES TAX CREDIT FOR MEALS MADE AVAILABLE TO HOTEL GUESTS

By Hollis L. Hyans

A New York State Administrative Law Judge held that a Manhattan hotel is not entitled to a tax credit for the amounts it paid to purchase continental breakfasts that it made available to hotel guests. *Matters of Washington Square Hotel LLC and Daniel Paul*, DTA Nos. 825405, 825505, & 825821 (N.Y.S. Div. of Tax App., Sept. 10, 2015).

Facts and Audit Issues. The Washington Square Hotel LLC owns and operates a hotel on Waverly Place in New York City. Its brochures indicate that the room rates include a continental breakfast, and state that a restaurant is also on the premises. As part of its contracts with travel companies, which also advertise that the room rates include a continental breakfast, the hotel provides rates for meals described as American breakfast for $15, lunch for $25, and dinner for $40. No rates for continental breakfasts are given.

On its sales tax returns for the period from December 1, 2007 through May 31, 2010, the hotel claimed a credit for sales tax it paid when it purchased continental breakfasts for provision to guests. On audit, the Department denied the credit because the hotel did not separately state the cost of the breakfast on the guests' bills, resulting in additional tax of approximately $300,000. The hotel also filed an application for a refund of approximately $22,000 on the same theory for the period December 1, 2011 to February 29, 2012; this refund was similarly denied by the Department.

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 if it is used in performing certain specified services. The service of providing hotel rooms for occupancy is not included within the specified qualifying services. Therefore, 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 sold to all guests, or that the price for each breakfast was separately stated on each invoice along with the applicable tax. Furthermore, the record contained no substantiation of the hotel's claim that credits were given to guests when the continental breakfast was not provided.

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 (1993), *lv denied*, 81 N.Y.2d 710 (1993), in which the Tax Appeals Tribunal found that a hotel's purchases 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 found that the hotel failed to demonstrate the value of the breakfasts or that the value was charged to each guest, since there was no separate charge on the hotel invoices for the breakfasts and no separate statement of sales tax.

[T]he sale of continental breakfasts as part of the service of providing hotel rooms does not fall within the sale for resale exclusion.

The ALJ also rejected the hotel's argument that it was a caterer or co-vendor with the on-site restaurant, finding no evidence of the sales of continental breakfast, the collection of tax, or even that any cost was ever associated with the continental breakfasts in the hotel's brochures.

Finally, the ALJ rejected the hotel's argument that the Department should be estopped from changing its position from that taken in earlier audits, determining that reference to a previous audit of the on-premises restaurant and correspondence by the restaurant's accountant did not reflect any determination made by the Department with regard to the hotel. However, the ALJ noted that the Department had previously audited the hotel, and while a previous audit does not bind the Department for the future, the hotel was claiming it had been instructed to claim a credit for taxes paid on the breakfasts. Since the audit papers for the previous audit had been destroyed, leaving an open question as to whether the hotel actually followed the instruction it had been given, the ALJ found it was not unreasonable for the hotel to continue to file its returns the same way over the

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past decade. She therefore found that reasonable cause existed and that penalties should be abated.

Additional Insights

Based on the ALJ's decision, the hotel in this case seemed to face two problems with its claims. First, as noted by the ALJ, the New York courts have affirmed the Tribunal's determination in *Helmsley* that, in general, items purchased by a hotel and provided to guests as part of overnight accommodations do not qualify for the resale exemption when they are initially purchased by the hotel. The Tribunal found in *Helmsley* that the purchased items did not retain their separate identity as tangible personal property when they were furnished to guests as part of services, and thus they were not purchases for "resale as such" as required by the statute. The Tribunal drew a distinction between the services 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.

Second, there appears to have been a basic proof problem, since it does not seem from the facts as recited by the decision that evidence was offered establishing how many guests actually availed themselves of the continental breakfast, or how it was valued, particularly in light of the fact that no prices were listed for continental breakfasts, while prices were separately stated for other meals.

INSIGHTS IN BRIEF

NYS Finds Taxpayer's Co-location Charges Are Not Subject to Sales Tax as Telephony

The New York State Department of Taxation and Finance has issued an Advisory Opinion concluding that space provided at a facility that provides a reliable, fail-safe place for customers to place their computer servers, along with telecommunications accessibility, is generally not subject to sales tax. *Advisory Opinion*, TSB-A-15(34)S (N.Y.S. Dep't of Taxation & Fin., Aug. 17, 2015). The Department concluded that separately stated charges for space within the facility are not subject to sales tax because they are charges for the lease of real property. The Department further concluded that charges for a hardwire connection within the facility, such as cross-connecting cabling so that a customer can connect to its own Internet service provider ("ISP"), are not charges for "telephony and telegraphy," and therefore not subject to sales tax. The Department found that where the facility operator itself purchases bandwidth from an ISP and resells that connection to its customers, those charges are for telephony and telegraphy, but are not subject to sales tax if the connection is used solely for Internet access and not voice communications.

Sales Tax Exemption Denied for Utilities Consumed in Washing Production Equipment

A New York State Administrative Law Judge has held that Costco was not entitled to an exemption from sales tax for the purchase of utilities used to power the pan, pot, and kettle washers that it employed to clean production equipment that was used in producing baked goods sold in its stores. *Matter of Costco Wholesale Corporation*, DTA No. 825882 (N.Y.S. Div. of Tax App., Aug. 27, 2015). The ALJ rejected Costco's argument that the utilities consumed by the pan washers, which were needed to comply with federal Food and Drug Administration sanitary requirements, qualified for the exemption from sales tax because they were used to create conditions necessary to complete the production process. The ALJ found that, under the statute and regulations, in order to qualify as exempt, the utilities must be used during the production phase of the process, and the utilities in question did not qualify because they "were used to clean and sanitize equipment before it ever came into contact with raw materials in the production process."

Failure to Comply With Bulk Sale Filing Procedures Results in Purchaser Liability

A New York State Administrative Law Judge found that a bulk sale purchaser of a liquor store was liable for sales tax owed by the seller at the time of the sale. *H & A Wine and Spirits, Inc.*, DTA No. 825984 (N.Y.S. Div. of Tax App., Sept. 10, 2015). The purchase contract contained a provision stating that there were no outstanding liabilities, and H & A filed a notification of the impending bulk sale as required by the statute, but failed to withhold from the amount paid funds to satisfy the Department's potential tax claim, of which it had been notified. Therefore, under the bulk sale statute, H & A was liable for the sales tax determined to be due from the seller. The ALJ found that, while claims by H & A that it relied upon the seller's representations that there were no liens and that its attorney failed to properly handle the matter might give rise to actions against the other parties, such claims could not absolve it from liability when it failed to retain sufficient funds from the sale to protect itself.

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Provider of Two-Way Radio Communications Systems Held Not Providing a Telecommunications Service

A New York State Administrative Law Judge held that a company that furnishes two-way radio communications systems to state and local public safety agencies in upstate New York is not providing a telecommunications service, and therefore is not subject to the New York State excise tax under Tax Law § 186-e. *Matter of New York Communications Company, Inc.*, DTA No. 825586 (N.Y.S. Div. of Tax App., Aug. 13, 2015). The fact that the provider used "repeater" equipment to facilitate radio transmissions over greater distances and around mountains and large buildings did not change the outcome. The ALJ concluded that the legislative intent was to subject to Tax Law § 186-e the furnishing of communication services of the type provided by telephone companies and common carriers of telephony, and not the type of communication service at issue.

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