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MoFo
New York Tax Insights

Tribunal Holds Government Financing Agreements Do Not Qualify as Investment Capital

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By Hollis L. Hyans

Reversing the decision of an Administrative Law Judge, the New York State Tax Appeals Tribunal has held that equipment financing agreements between Xerox Corporation and various governmental entities did not qualify as "investment capital," and denied the refund sought by Xerox. *Matter of Xerox Corporation*, DTA No. 822620 (N.Y.S. Tax App. Trib., Jan. 12, 2012).

At issue in this case was interest income earned by Xerox from financing agreements entered into with governmental entities. In various types of leases and installment sale arrangements, which allowed the governmental entities to pay for equipment over a period of time, Xerox received payment for the equipment it provided, plus interest income.

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Government Financing Agreements Are Not Investment Capital

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For federal income tax purposes, some of the arrangements were treated as installment sales and some were treated as true leases. Income on certain of the leases was excluded from federal taxable income pursuant to Internal Revenue Code § 103. With other leases, Xerox treated both the principal and the interest portions as rental revenue for federal income tax purposes.

On its original New York State franchise tax returns for 1997 through 1999, Xerox treated the revenue from all the leases as business income. It later submitted refund claims and amended returns, reclassifying as investment income the interest income that arose from the finance leases with the governmental agencies. The Department of Taxation and Finance denied the refund claims, maintaining that the interest income was properly treated as business income.

IN ORDER TO QUALIFY AS "SECURITIES," ASSETS MUST, IN ADDITION TO BEING AN INVESTMENT OF MONEY, REPRESENT AN INVESTMENT IN A COMMON ENTERPRISE, WITH PROFITS EXPECTED TO RESULT SOLELY FROM THE EFFORTS OF OTHERS.

Classification of income as arising from business capital or investment capital. Tax Law § 208(5) defines "investment capital" as "investment in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business…." Both the Department and Xerox agreed that the financing agreements did not qualify as either stocks or bonds. However, Xerox argued that they were "other securities." Prior to December 1989, the Department's regulations limited "other securities" to instruments that, among other requirements, were "'designed as a means of investment, and issued for the purpose of financing corporate enterprises and providing a distribution of rights in, or obligations of, such enterprises' 20 NYCRR former 3-4.2[c]." That regulation was amended effective December 7, 1989, to provide that "stocks, bonds and other securities" includes "debt instruments issued by the United States, and state, territory or possession…." 20 NYCRR 3-3.2(c)(1) and (2).

The ALJ decision. In October 2010, an ALJ ruled in favor of Xerox, finding that the regulatory definition of "other securities" included in investment capital clearly encompassed "debt instruments issued by [governmental entities]" 20 NYCRR 3-3.2(c)(2), and rejecting any reliance on the former version of the regulation. In addition, the ALJ held that the Department could not apply to *governmental* debt instruments restrictions in the current regulations stating that *corporate* debt instruments do not qualify as investment capital if acquired by the taxpayer for services rendered or for the sale or rental of property.

The Tribunal Decision. Unlike the ALJ, the Tribunal focused its analysis not on the regulation but on the statute, finding that, in order to qualify as "other securities," the items must first be found to be "securities." The Tribunal then turned to the State securities law and found that, in order to qualify as "securities," assets must, in addition to being an investment of money, represent an investment in a common enterprise, with profits expected to result solely from the efforts of others. The Tribunal relied principally on a decision by the United States Supreme Court in *Securities & Exch. Comm'n v. W.J. Howey Co.*, 328 U.S. 293 (1946), in which the issue was whether units of a citrus grove development, consisting of a land sales contract, a warranty deed and a service contract, constituted an "investment contract" within the meaning of § 2(1) of the Securities Act of 1933. The Tribunal found that Xerox's leases and installment sale agreements did not satisfy the tests used in *Howey*, since there was no "commonality between the investment and the return." Here, the Tribunal found that the financing transactions generated revenue under their own terms, not on the basis of any venture by the government agencies. There was also no "expectation of profits solely from the work of others," which would require a showing that the third party's efforts are the significant ones, "'essential managerial efforts which affect the failure or success of the enterprise.'" Therefore, the Tribunal determined that the financing arrangements did not qualify as "securities" under *Howey*.

Although finding that test "dispositive," the Tribunal then went on to consider the financing arrangements under the language of *Matter of Waldstein*, 160 Misc. 763, 767 (N.Y. Sup. Ct. 1936), which had found that burial certificates which were "evidence of interest … and indebtedness" were in the nature of securities. The Tribunal found that the leases and installment sales did not meet the requirements of *Waldstein*, since they were designed as product leases and sales, not to finance corporate enterprises. Finally, the Tribunal also found relevant the fact that the instruments were "created in petitioner's ordinary course of business," and that the business nature of the transactions did not change "because the sales involved extensions of credit to customers."

Additional Insights. Understanding the differences between "business capital" and "investment capital"—a distinction unique

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Government Financing Agreements Are Not Investment Capital

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to the tax laws of New York State and New York City and used by no other jurisdiction—has long been a thorny issue. The Department's revision of its regulations back in 1989 was designed to eliminate some of the confusion, but disputes continue.

Here, the Tribunal based its analysis almost entirely on definitions of the term "securities" from sources outside the Tax Law, relying primarily on definitions from a case decided by the United States Supreme Court in 1946 and a decision by a New York trial court in 1936, which looked to whether or not there was a pooling of funds in a shared enterprise designed for the earning of profit. However, these considerations seem very similar to those that were contained in the *previous* incarnation of the Department's regulations, which were eliminated in the 1989 revision, leaving only the language that, in order to qualify as "stocks, bonds and other securities," an instrument need only be "issued by the United States…." The Tribunal does not explain why a test so similar to the language expressly eliminated by the Department from its regulations in 1989 should still govern. In addition, although the statute and the regulations both clearly contemplate the treatment as investment capital of some debt instruments issued by governmental agencies, the Tribunal decision leaves unanswered what other U.S. debt instruments would qualify under the tests of *Howey* or *Waldstein*, neither of which concerned government obligations in any way.

The question of the importance of the intent of the taxpayer in making the determination of investment or business capital is one that has surfaced before, with inconsistent results, although again not in cases involving government obligations. For example, in *Matter of RCA International Development Corporation*, TAT (E) 93-32 (GC) (N.Y.C. Tax App. Trib., Dec. 20, 1996), the New York City Tax Appeals Tribunal held that because the company had failed to establish that the instruments in question, debt instruments issued by an affiliate of the taxpayer, were "designed as a means of investment from its perspective," they could not be treated as investment capital. On the other hand, in a nonprecedential decision, a New York State ALJ, in *Matter of McGraw-Hill, Inc.*, DTA No. 812371 (N.Y.S. Div. of Tax App., Sept. 21, 1995), found that the business-related motivations of McGraw-Hill, in purchasing shares in the company that owned the building in which it maintained its corporate headquarters, as it was required to do in order to lease the space, did not convert the interest from investment capital to business capital. Although ruling for McGraw-Hill on other grounds, the ALJ found that, "while undoubtedly having ties to petitioner's business operations … the stock purchase qualifie[d] as an investment."

The next step in this dispute, if Xerox pursues its position, would be the filing of a petition for review with the Appellate Division, Third Department, which must be done within four months of the Tribunal's decision.

Governor Cuomo Releases 2012-13 Executive Budget

By Irwin M. Slomka

On January 17, 2012, New York State Governor Andrew Cuomo released the 2012-13 New York State Executive Budget. The budget included several important tax proposals, none of which can be considered broad-based in scope. The somewhat narrow nature of the proposals may be in recognition of the Governor's recent creation of a Tax Reform and Fairness Commission, which will address long-term changes to the State tax system. Unlike in the past few years, the bill contains no so-called "tax loophole closers," which presumably also will be reviewed by the new Commission. Among the proposed legislative changes are the following:

- **Expand criteria to refuse to issue sales tax certificates of authority**. The bill would allow the Department to deny to a vendor a certificate of authority for sales and use tax if the vendor owes any unpaid tax, not just unpaid sales tax.
- **Make permanent certain electronic filing and sales tax compliance provisions.** The bill would make permanent the requirement that individuals using tax software to prepare their State personal income tax returns must file their returns electronically. The existing requirement is scheduled to expire on December 31, 2012. The bill would also make permanent a 2011 enactment under which certain sales tax vendors, upon notification by the Department, are required to set up separate bank accounts used solely for depositing sales tax collections, and accessible to the Department.
- **Prohibit banks from charging processing fees on levied bank accounts.** The bill would overrule decisions of the New York State courts under existing State law and prohibit banks from deducting bank processing fees out of the proceeds from bank accounts levied to collect delinquent State taxes or child support obligations.

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Governor Cuomo Releases 2012-13 Executive Budget

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- **Allow lower Metropolitan Commuter Transportation Mobility Tax rates to professional employer organizations.** In 2011, the Metropolitan Commuter Transportation Mobility Tax rates were reduced for small businesses. The bill would make the lower rates available to professional employer organizations, which often serve as the employer of record for small businesses to provide employee benefits in a cost-efficient manner, but that otherwise do not qualify for the lower rates because of their size.

- **Reform the Tobacco Products Excise Tax.** The Governor's Memorandum in Support states that some cigarette purchasers use commercial roll-your-own machines to make cigarettes using loose tobacco, and thereby pay a lower tobacco products excise tax rather than the much higher cigarette tax. The bill would tax all loose tobacco at the same rate as the cigarette excise tax.

- **Authorize program to deny STAR exemption benefits for taxpayers with past-due tax liabilities**. The bill would authorize the Department to establish a new program to permit the State to recover STAR benefits (generally available for property tax and personal income tax) from taxpayers who owe certain past-due State tax liabilities.

- **Extend or expand various State tax credits and exemptions.** Among the tax credit and exemption programs expanded or extended under the bill are the sales and personal income tax exemption for solar energy systems equipment, the biofuel production tax credit, and the Empire State Commercial Production tax credit for filming commercials in the State.

The Department had already announced that its "corporate tax reform" proposal would not be part of this year's revenue bill.

THE SOMEWHAT NARROW NATURE OF THE PROPOSALS MAY BE IN RECOGNITION OF THE GOVERNOR'S RECENT CREATION OF A TAX REFORM AND FAIRNESS COMMISSION, WHICH WILL ADDRESS LONG-TERM CHANGES TO THE STATE TAX SYSTEM.

State Rules That Per-Use Fees for Laser Surgery Equipment Are Presumed Subject to Sales Tax

By Irwin M. Slomka

In an interesting sales tax Advisory Opinion that invokes a "presumption" of taxability, the New York State Department of Taxation and Finance has ruled that a seller of laser surgery equipment that also charges equipment purchasers a per-use fee is presumed to be making taxable sales with respect to those fees, principally because the taxpayer did not show that the fees were for patents that were not incorporated into the equipment. *Advisory Opinion*, TSB-A-11(32)S, December 7, 2012.

The taxpayer sells laser surgery equipment used for cataract and other eye surgery. Under the taxpayer's standard sales contract, a purchaser must pay, in addition to an upfront charge for the equipment, a "refractive per-procedure fee" of $100 for each procedure performed using the laser equipment. In addition, the purchaser must buy, for $10, a plastic "treatment" card from the taxpayer that must be inserted into the equipment each time the equipment is used for laser surgery. The total of the $100 plus the $10 plastic card fee are billed together.

The taxpayer paid a per-procedure surgery license fee to Visx, Inc. for its patented laser surgical procedures, due for every laser correction surgery performed using the taxpayer's surgical equipment. The amount of the fee paid by the taxpayer was not disclosed in the Advisory Opinion. The sales contract between the taxpayer and its customers refers to the granting of a sublicense to the customers under the Visx patents.

The taxpayer, contending the per-procedure fee it received was for sublicensing patent procedures, sought a ruling that the fee is a royalty, and thus not subject to sales tax. It is not clear from the Advisory Opinion whether the taxpayer was contesting taxability of the $10 plastic card fee. The sale of the surgical laser equipment was itself subject to sales tax because the statutory exemption for medical equipment and supplies does not apply when the equipment is sold to a person who performs medical services for compensation, such as sales to physicians and hospitals. Tax Law § 1115(a)(3).

The Department ruled that the per-procedure fee was subject to sales tax. According to the Department, the taxpayer bears the burden of showing that the license fee is for a patent that is *not*

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Laser Surgery Fees Subject to Sales Tax

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incorporated into the taxpayer's laser equipment (in which case it would be an expense pertaining to the sale of the equipment) or into the software of the equipment (making it an expense relating to the sale of prewritten software).

As for the taxpayer's claim that this was nothing more than a nontaxable sublicense of a patented surgical procedure, the Advisory Opinion stated that the taxpayer "offers no clear guidance as to whether the patent is in fact incorporated into the hardware or software of the laser." However, according to the Department, it was "highly probable" that Visx's patented medical surgical procedure is incorporated into the equipment hardware or software. Thus, "until [the taxpayer] can establish that no incorporation of the patent into the laser surgery equipment has occurred, the fee will be presumed subject to sales tax," as an expense pertaining to either the sale of equipment or the sale of prewritten software. The Department also found the plastic card fee was a taxable sale of tangible personal property, inasmuch as it was necessary to activate the laser surgery equipment.

Additional Insights. Given the Department's view that the taxpayer did not show that the Visx patents were *not* incorporated into the surgical equipment or related software – in effect, failing to prove a negative – the Department could have declined to issue an Advisory Opinion on the grounds it required an inherently factual determination. Instead, it invoked a presumption of taxability (contained in Tax Law § 1132(c)) that is typically applied to receipts from retail sales of tangible personal property. But since the issue here was whether the receipts were in fact for the sale of tangible personal property, the applicability of the presumption to these charges seems tenuous.

ALJ Accepts Unsigned Tax Return Disavowed By Taxpayers

By Open Weaver Banks

A New York State Administrative Law Judge declined to address the legitimacy of an unsigned personal income tax return because the Department accepted the amounts reported on the return and the adjustments on the return inured to the taxpayers' benefit.

In *Matter of Patrick C. and Anne M. Kennedy*, DTA No. 823722 (N.Y.S. Div. of Tax App., Jan. 12, 2012), the Department issued a Notice of Deficiency after discovering a discrepancy between the taxpayers' reported adjusted gross income for federal purposes and the amount reported on their New York return. Subsequently, the Department received a second New York return in the taxpayers' names. Although the return was unsigned, the Department accepted the amounts reported on the second return and reduced the taxpayers' deficiency to $201, plus interest.

In support of their petition for redetermination, the taxpayers claimed they did not know that the second return existed until the Department provided them with a copy. They also asserted that they never authorized any person or entity to file such a return on their behalf and that they did not file any amended return for the year at issue.

WHILE AN ALJ MAY TAKE OFFICIAL NOTICE OF ALL FACTS OF WHICH JUDICIAL NOTICE COULD BE TAKEN AND OF OTHER FACTS WITHIN THE SPECIALIZED KNOWLEDGE OF THE AGENCY, THE ALJ EXPLAINED THAT COURTS NEED NOT TAKE JUDICIAL NOTICE OF RECORDS OF PROCEEDINGS IN OTHER COURTS.

The taxpayers in *Kennedy* also requested the Division of Tax Appeals to take judicial notice of a complaint they filed with the New York State Attorney General's office relating to "aspects of this matter." The ALJ declined to take notice of the complaint filed with the Attorney General's office or any work performed by that office in connection with the complaint. While an ALJ may take official notice of all facts of which judicial notice could be taken and of other facts within the specialized knowledge of the agency, the ALJ explained that courts need not take judicial notice of records of proceedings in other courts. Accordingly, the ALJ found that it was appropriate to decline to take official notice of the records of the Office of the Attorney General, an agency separate from the Division of Tax Appeals.

In *Kennedy*, the ALJ concluded that the taxpayers did not meet their burden of establishing error in the Notice of Deficiency, as revised by the Department after the receipt of the second return. The taxpayers did not contest their original return or the federal tax information on which the Notice of Deficiency was based. The ALJ found the taxpayers' denial of the legitimacy of the unsigned second return "curious," since the Department's consideration of the second return eliminated nearly all of the deficiency, and without the second return there was no other basis for adjusting the deficiency. Considering that the adjustments

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ALJ Accepts Unsigned Tax Return

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resulting from the second return inured to the taxpayers' benefit, the ALJ found it unnecessary to address the legitimacy of the second return and denied the taxpayers' petition.

Additional Insights. While the instructions to the New York Resident Income Tax Return state that an unsigned return cannot be processed, that was not the case in *Kennedy*, where the Department relied upon the information in the second return to recompute the taxpayers' deficiency. However, if the second return had instead increased the taxpayers' liability, the Division of Tax Appeals may well have entertained their arguments as to the legitimacy of the unsigned return. Unfortunately, this decision leaves unanswered several questions, including why the taxpayers challenged the legitimacy of the second return at all, particularly with only $201 at issue and, if in fact the taxpayers did not file the second return, who did file it and why?

As to the ALJ's refusal to take official notice of a complaint filed with the Office of the Attorney General, the *Kennedy* decision raises an interesting evidentiary point. Under N.Y. A.P.A. Law § 306(4), governing evidence in adjudicatory proceedings, "official notice" *may* be taken of all facts of which judicial notice could be taken and of other facts within the specialized knowledge of the agency. New York courts *may* take judicial notice of their own record, of the proceeding of the case before them, the records of cases involving one or more of the same parties, or the records of cases involving totally different parties. In this regard, there are numerous examples of ALJs taking official notice of records of other proceedings in the Division of Tax Appeals. *See, for example*, *Matter of Trifon Kolovinas*, DTA No. 803073 (N.Y.S. Tax App. Trib., Dec. 28, 1990) (in a proceeding involving a party allegedly responsible for sales tax due from a company, official notice was taken of a fact established at the hearing involving the company).

An ALJ may also take official notice of facts within common knowledge, such as the location of the Empire State Building (*Matter of Sumitomo Trust and Banking Co. (USA)*, DTA No. 815381 (N.Y.S. Tax App. Trib., Sept. 9, 1999), *aff'd*, 720 N.Y.S. 2d 251 (3d Dep't 2001)) or even the health consequences of using cigarettes (*Matter of Muhammad Kamal*, DTA No. 821701 (N.Y.S. Div. Tax App., Apr. 9, 2009), *aff'd*, (N.Y.S. Tax App. Trib., Feb. 11, 2010).

Additionally, an ALJ may take official notice of Department forms and instructions. In *Matter of Jessie Luongo*, DTA Nos. 822823 and 822517 (N.Y.S. Div. of Tax App., Apr. 28, 2011), the ALJ took official notice of the Department's instructions for an application for registration as a sales tax vendor, explaining that the use of such instructions was clearly within the "specialized knowledge" of the agency.

However, petitioners to the Division of Tax Appeals should not assume that official notice will be given to matters or records of other New York agencies. For example, in *Matter of O & R Energy, Inc. N/K/A Norstar Holdings, Inc.*, DTA Nos. 815488 (N.Y.S. Div. of Tax App., Aug. 6, 1998), the ALJ refused to take official notice of "the general characteristics of amnesty programs and voluntary disclosure programs." Thus, it is important to build a factual record based upon stipulations, testimony and exhibits properly entered into evidence before the ALJ.

Proof of Mailing of Unsigned Conciliation Order Sufficient to Start 90-Day Protest Period

By Kara M. Kraman

The Tax Appeals Tribunal has held that the 90-day time limit to file a petition with the Division of Tax Appeals commenced upon the mailing of the Conciliation Order, although the Department failed to establish proper mailing of the original Notice of Determination. *Matter of Verma Deepak*, DTA No. 823623 (N.Y.S. Tax App. Trib., Dec. 22, 2011). The Tribunal affirmed the decision of the ALJ which held that the Division of Tax Appeals lacked jurisdiction to address the merits of the taxpayer's petition because the 90-day time limit for filing the petition had expired.

In May 2010, Verma Deepak filed a petition challenging an assessment of sales and use taxes in the amount of $732,000 for the period June 1, 1988 through August 31, 1991. In his petition, Mr. Deepak alleged that he had never received a copy of the Notice of Determination at his last known address, by certified mail, as required by law, and for that and other reasons, the Notice should be cancelled. In his petition -- filed after he received a copy of the Notice pursuant to a Freedom of Information Law request -- Mr. Deepak checked the box indicating that "[a] conciliation conference was not requested."

The Department claimed the Notice of Determination had been mailed on December 9, 1994, but conceded that it could not establish proper mailing of the Notice. However, the Department alleged that notwithstanding the check-marked box on the petition, a conciliation conference was in fact held in October 1995, and resulted in a reduction of the amount of tax assessed from $732,000 to $362,000.

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Proof of Mailing of Unsigned Conciliation Order Sufficient to Start Protest Period

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The Department asserted that a Conciliation Order sustaining the reduced assessment was issued to Mr. Deepak in November 1995. As support for its assertion, the Department produced two affidavits from Department personnel describing its general mailing procedure and the mailing record which showed that the procedure had been followed in this case, and an *unsigned*, printed copy of the November 1995 Conciliation Order in which Mr. Deepak's name was misaligned in the caption box. The Department explained that it was unable to produce a signed copy of the Order because its policy is to destroy paper records after six years. It sought dismissal of Mr. Deepak's petition as untimely. Mr. Deepak maintained that the Department not only failed to prove proper mailing of the Notice, it was unable to produce a signed copy of the Conciliation Order. He claimed that he received neither.

ONCE THE CONCILIATION ORDER WAS FOUND TO HAVE BEEN PROPERLY MAILED BY THE DEPARTMENT, THE BURDEN SHIFTED TO [THE TAXPAYER] TO PROVE THAT A TIMELY PROTEST WAS FILED.

Under New York law, it is sufficient if, "for the sole purpose of establishing the timeliness of the petition, a legible copy of the order of the conciliation conferee" is produced. Tax Appeals Tribunal Rules of Practice and Procedure § 3000.3(b)(8). The Tribunal noted that there is no requirement in the rules that the Conciliation Order be signed, only that it be legible. Noting that Mr. Deepak did not produce any evidence challenging the affidavits of Department personnel, and that the unsigned Conciliation Order was legible and contained all of the relevant case information, the Tribunal held that the Department met its burden of proof establishing proper mailing of the Conciliation Order.

As a result, the Tribunal concluded that the statutory 90-day time limit to file a petition challenging the assessment commenced in November 1995, when the Conciliation Order was mailed. The Tribunal then noted that once the Conciliation Order was found to have been properly mailed by the Department, the burden shifted to Mr. Deepak to prove that a timely protest was filed in response to the Conciliation Order. As Mr. Deepak's protest was not filed until May 2010, the Tribunal held that the Division of Tax Appeals had no jurisdiction to proceed with the matter.

Additional Insights. The Tribunal's decision involves the somewhat unusual situation where the Department cannot establish proper mailing of its Notice, but nonetheless was able to prevail because it successfully relied on the presumption of receipt arising from the proper mailing of a Conciliation Order. The taxpayer's claim that he never received the Department's Notice could not be reconciled with the fact that a conciliation conference was held after the Notice was issued -- meaning that a petition must have been filed following receipt of the Notice -- regardless of the Department's inability to produce a signed copy of the Conciliation Order.

Insights in Brief

Golf Course Membership Dues Not Subject to Sales Tax

In a recent Advisory Opinion, the Department has ruled that membership dues paid for membership in a golf course facility open to the public are *not* subject to sales tax as taxable dues paid to a "social or athletic club." *Advisory Opinion*, TSB-A-11(33) S, Dec. 20, 2011. The Department's rationale was that because the membership fees do not in fact give the "members" any ownership interest or control over the activities or management of the privately run golf course, and because membership is not restricted, the club was not a "social or athletic club."

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