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Appellate Court Holds "Reconstitution" of Housing Cooperative Is Not Subject to City Transfer Tax

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By Irwin M. Slomka

Reversing a decision of a Kings County Supreme Court judge, the Appellate Division has unanimously held that a residential housing cooperative corporation's termination of its participation in the Mitchell-Lama Housing Program did not result in a transfer of real property within the meaning of the New York City real property transfer tax law, and therefore was not subject to the tax. *Trump Vill. Section 3, Inc. v. City of New York*, 2012 NY Slip Op. 6595 (App. Div., 2d Dep't, Oct. 3, 2012).

Trump Village Section 3, Inc. ("Trump Village"), is the owner of a residential housing cooperative complex consisting of three 23-story buildings located in Brooklyn, New York. When formed in 1961, Trump Village took title to the real property pursuant to the Mitchell-Lama housing program, a program enacted in the 1950s to foster affordable housing in the State for moderate-income families. Under the Mitchell Lama program, the cooperative corporation enjoyed substantial government benefits, but tenant-shareholders were restricted in their ability to make resales to third parties.

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"Reconstitution" of Housing Cooperative Not Subject to Transfer Tax

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After paying off its government mortgage loan in 2005, the shareholders of Trump Village voted in 2007 to terminate participation in the Mitchell-Lama program. As a result, under the Private Housing Finance Law, the corporation "voluntarily dissolved." It did so by "reconstituting" itself as a corporation under the Business Corporation Law. The "reconstitution" involved amending all references to the Private Housing Finance Law in the certificate of incorporation. New shares of stock in the "reconstituted" cooperative were not issued, although the existing stock certificates were amended to remove language pertinent to the Mitchell-Lama program. The shareholders, the number of shares, and the cooperative corporation's federal tax identification number all remained the same before and after the "reconstitution," and no deed was made or recorded.

The Department of Finance assessed $21 million in real property transfer tax ("RPTT"), penalty, and interest against Trump Village, asserting that the transaction involved a conveyance of real property to a new corporation. Trump Village brought a declaratory judgment action in court seeking a declaration that the RPTT was inapplicable. In 2011, a Kings County Supreme Court judge granted summary judgment to the Department, holding that Trump Village had "transferred" or "conveyed" real property. Trump Village appealed.

The Appellate Division, Second Department, unanimously reversed the decision, holding that Trump Village had demonstrated that it had not transferred or conveyed real property within the meaning of the RPTT law. The court began its analysis with the maxim that any doubts as to the scope and application of a tax are to be resolved in favor of the taxpayer. The court then considered the competing arguments: Trump Village argued that a "reconstitution"—a term used in the Private Housing Finance Law, but not in the RPTT law—involves no deed, delivery, grantor, or grantee. The Department claimed that the voluntary dissolution and reconstitution resulted in the formation of a new corporation, and thus the amended certificate of incorporation was in effect a "deed" subject to tax.

The appellate court found no support for the Department's position, noting that Trump Village remained the same legal entity both before and after the "reconstitution." Moreover, the court found no basis for interpreting the term "deed" to include an amendment to a corporation's certificate of incorporation. The Department also argued that the "mere change in form" exemption under the RPTT, by its express terms, does not apply to a conveyance to a cooperative housing corporation. The court held that the exemption provision was not relevant since the tax was inapplicable in the first instance.

Additional Insights. The Appellate Division decision reaches the correct result, since it is difficult to see how the mere act of amending a certificate of incorporation can be considered a "transfer" or "conveyance" of real property from a grantor to a grantee. The court properly viewed Trump Village as the same legal entity throughout, albeit thereafter it was authorized under a different New York law and without the restrictions imposed under the Mitchell-Lama program. The decision reaches a result on nontaxability similar to that in an earlier court decision in *Joint Queensview Housing Enterprise, Inc. v. Grayson* (Sup. Ct., N.Y. Cty. 1990), *rev'd on other grounds*, 179 A.D.2d 434 (1st Dep't 1992). There, a comparable "reconstitution" under a different section of the Private Housing Finance Law was also held not subject to RPTT, although the decision was later reversed on the grounds that the decision had been premature since no tax had yet been assessed by the Department of Finance.

Trial Court Upholds Retroactive Application of 2010 Statutory Amendment

By Hollis L. Hyans

Rejecting a claim by taxpayers that retroactive application violated their due process rights, a judge in the Supreme Court, New York County, has upheld the application of statutory changes made in August 2010 to the treatment of the distribution of installment obligations to the nonresident shareholders of an S corporation for the 2007 and 2008 tax years. *Caprio v. New York State Dep't of Taxation & Fin.*, 2012 NY Slip Op. 22273 (Sup. Ct. N.Y. Cty. Sept. 22, 2012).

The plaintiffs, Mr. and Mrs. Caprio, were nonresidents of New York. They were the sole shareholders of an S corporation doing business as TMC Services, Inc. ("TMC"), which derived a portion of its income from activities in New York. In 2007, the Caprios sold all of their shares in TMC to a third party for a "base purchase price" of approximately $19.9 million, plus a contingent purchase price based on TMC's financial performance for 2007, 2008, and 2009. The agreement required the purchaser to pay approximately $19.4 million plus interest in 2007, and the

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remaining $500,000 plus interest in 2008, under promissory notes referred to as "Installment Obligations."

For federal income tax purposes, the Caprios and the purchaser made an election under Internal Revenue Code § 338(h)(10) to treat the stock sales as a sale by TMC of its assets to the purchaser in return for the Installment Obligations, followed by a deemed liquidation and distribution to its shareholders of the consideration received from the purchaser. In addition to the § 338(h)(10) election, the Caprios elected to report the gain from the deemed asset sale under the installment method, pursuant to IRC § 453, under which gain is recognized only when cash payments are actually received. The Caprios reported a capital gain on their 2007 federal income tax returns of approximately $18.2 million, and an additional gain of approximately $1.1 million in 2008.

They reported these amounts on their 2007 and 2008 New York nonresident income tax returns as payments received under the installment method in exchange for stock in TMC. The Caprios took the position that the gain should be treated as income from the sale of stock, and therefore not New York-source income, since, under Tax Law § 631(b)(2), gain from the sale of an intangible asset such as stock is not included in the taxable income of a nonresident unless the gain is from property employed in a trade or business in New York.

Previous Litigation and Statutory Amendment. In 2009, an Administrative Law Judge held that, under Tax Law § 632(a)(2), nonresident shareholders did not have New York-source income when they sold their stock in an S corporation under an installment agreement. *Matter of Mintz*, DTA Nos. 821807 & 821806 (N.Y.S. Div. of Tax. App. June 4, 2009). A similar decision had been reached by the Tax Appeals Tribunal in *Matter of Baum*, DTA Nos. 820837 & 820838 (N.Y.S. Tax App. Trib. Feb. 12, 2009). In August 2010, Tax Law § 632(a)(2) was amended to specifically provide that gain recognized by a nonresident shareholder of an S corporation, arising from payments received under an installment obligation, will be treated as New York-source income based on the S corporation's New York business allocation percentage for the year in which the assets were sold. The amendment was made applicable to years beginning on or after January 1, 2007, that were open to assessment or refund.

In February 2011, the Department of Taxation and Finance issued Notices of Deficiency to the Caprios for 2007 and 2008, seeking additional tax and interest of more than $700,000. The Caprios brought suit in New York Supreme Court, a trial court, claiming that the application of the 2010 amendment to § 632(a)(2) to their 2007 and 2008 tax returns was unconstitutional under the Due Process Clauses of the United States and New York Constitutions. They argued that the 2010 amendments for the first time imposed a tax on gain recognized on payments received from installment obligations under IRC § 453(h)(1)(A), and that the three-and-a-half-year period of retroactivity was excessive.

The court found initially that the Caprios were not required to exhaust administrative remedies before the Division of Tax Appeals, since they were challenging the statute's constitutionality. However, it then determined that the retroactive application was appropriate.

First, it reviewed the general standard, finding that retroactive application of tax statutes did not necessarily infringe upon due process rights, and that courts were required to consider the nature of the tax and circumstances at issue. The Caprios claimed that the new statutory language enacted a "wholly new tax," which the court noted might run afoul of due process requirements if not limited to a short period of retroactivity. Here, the court agreed with the Department that the 2010 amendments did not create a new tax but were simply "'curative or clarifying measures'" intended to correct erroneous determinations by an ALJ in *Mintz* and by the Tax Appeals Tribunal in *Baum*, and were merely intended to "clarify and ratify what the Department… had long believed was already clear in the existing statutes." The court further determined that the legislative findings accompanying the amendment indicated that it was intended to clarify the existing statute and correct what were viewed as erroneous determinations in *Mintz* and *Baum*. Since the statute itself provided for retroactivity back to 2007, taxpayers "would reasonably expect that so long as the statute of limitations period remained open…the Department…could impose an additional assessment."

THE COURT AGREED WITH THE DEPARTMENT THAT THE 2010 AMENDMENTS DID NOT CREATE A NEW TAX BUT WERE SIMPLY "'CURATIVE OR CLARIFYING MEASURES'" INTENDED TO CORRECT ERRONEOUS DETERMINATIONS BY AN ALJ IN *MINTZ* AND BY THE TAX APPEALS TRIBUNAL IN *BAUM*.

While the Caprios argued that any retroactivity period should

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extend no further back than the year of the legislative session preceding the enactment, the court rejected that argument, finding that both federal and New York courts have approved retroactivity periods longer than one year.

The Caprios also argued that they structured the 2007 stock sale in reliance on the previous interpretation, which was upheld in *Mintz*, and that the Department, by failing to appeal the decision in *Mintz* and instead seeking a legislative remedy, knew that the existing law did not impose a tax in these circumstances. The court rejected this argument, noting that ALJ determinations have no precedential value, so a taxpayer cannot reasonably rely on them, and that, since the *Mintz* decision was issued in 2009, the Caprios could hardly have relied on it in structuring their transaction in 2007. The court found persuasive the evidence offered by the Department about its longstanding interpretation of § 632(a)(2), and found that the *Mintz* and *Baum* decisions in 2009 were "aberrational."

Additional Insights. This decision illustrates some of the difficulties inherent in litigating state tax disputes. Here, other taxpayers had litigated very similar issues, and both an Administrative Law Judge, whose decisions are not precedential, and the Tax Appeals Tribunal, whose decisions *are* precedential, had disagreed with the Department's interpretation of the statute. Since the taxpayer was successful before the Tribunal in *Baum*, the Department had no right to appeal the decision, and decided against appealing *Mintz*. Instead, the Department took the alternative course of seeking and obtaining a statutory amendment. Nonetheless, both an ALJ and the Tax Appeals Tribunal had found that the original statute did not provide for the interpretation urged by the Department. When taxpayers who lose before the Tax Appeals Tribunal appeal those decisions to the Appellate Division, the Department customarily argues that the decisions of the Tribunal are entitled to great deference. Here, the Department seemed to be saying just the opposite: that the Tax Appeals Tribunal was wrong, had always been wrong, and no reliance at all can be placed on its decisions, so that taxpayers and their advisors who similarly believed they understood the statute remain at risk. To the extent the Department finds a need to amend a statute to enforce its interpretation—even if it had always believed its interpretation was correct—the better policy might perhaps be to acknowledge that taxpayers who took the opposite position had been joined in their thinking by an ALJ and the Tribunal, and to apply the new statute prospectively only.

Tribunal Holds S Corporation Shareholder Is a New York Resident, but His Corporation Is Not Subject to the Corporate Tax

By Open Weaver Banks

Affirming a decision of an Administrative Law Judge, the New York State Tax Appeals Tribunal has held that an individual failed to prove that he was not a New York domiciliary during 2001 and 2002, and that the Schedule K-1 income he received from a federal S corporation was properly included in his New York State adjusted gross income because the S corporation was not subject to the corporation franchise tax. *Matter of Philip Terranova*, DTA No. 822699 (N.Y.S. Tax App. Trib., Sept. 20, 2012).

Facts. Until 1999, Mr. Terranova resided in Amherst, New York. Following the sale of his home in that year, Mr. Terranova moved into a home owned by his parents in Buffalo, New York, and moved his personal items from his former residence into storage. In lieu of paying rent to his parents, Mr. Terranova performed repair and maintenance on the residence.

For each of the years 2001 and 2002, Mr. Terranova filed New York nonresident and part-year resident tax returns, claiming to have an address in Florida. On audit, the Department of Taxation and Finance determined that Mr. Terranova failed to provide clear and convincing evidence that he had changed his domicile from New York to Florida. In particular, the Department found Mr. Terranova was only present in Florida for 11 days in 2001 and nine days in 2002.

The Proceedings Before the ALJ. Mr. Terranova had relied on various evidence indicating that he moved to Florida in 2001, including construction of a new home in Florida, acquisition of a Florida driver's license, and Florida voter registration. At the hearing before the ALJ, however, Mr. Terranovar admitted that he "never really spent a significant amount of time in Florida" in the years 2001 and 2002.

Mr. Terranova owned and ran several business operations, including Niagara Chocolates, Inc. ("Niagara Chocolates"), a family business that manufactured chocolate in New York, and Oak Leaf Confections of North America, Inc. ("Oak Leaf"), a federal S corporation that manufactured chewing gum and other types of candy in Canada. In addition to running the business of Niagara Chocolates, which had facilities a short distance from his

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Tribunal Holds S Corporation Shareholder is a New York Resident

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parents' home, Mr. Terranova also worked at Oak Leaf's Toronto facilities on a regular basis in the years 2001 and 2002.

In computing his New York adjusted gross income reported on his nonresident income tax return for the year 2001, Mr. Terranova did not subtract the K-1 income in the amount of $2,233,979 received from Oak Leaf from his federal adjusted gross income reported on that return. However, during the audit Mr. Terranova claimed that the flow-through income from Oak Leaf should not have been included in his New York adjusted gross income because Oak Leaf was a foreign corporation subject to tax under Article 9-A, even though Oak Leaf did not file a New York State corporation franchise tax return.

[T]HE TRIBUNAL NOTED THAT ACTIVE BUSINESS TIES TO NEW YORK HAVE BEEN CONSIDERED AN INDICATION OF A FAILURE TO ABANDON A NEW YORK DOMICILE.

Mr. Terranova relied on the following facts provided in his own affidavit to describe the activities of Oak Leaf: (1) Oak Leaf was an S corporation for federal purposes but did not make an election to be a New York S corporation; (2) Oak Leaf had more than $1 million in New York sales in 2001, which were made by a broker on Oak Leaf's behalf; and (3) from time to time Oak Leaf's inventory was warehoused at the facilities of Niagara Chocolates in New York; this fact was supported by copies of eight invoices for the shipment of Oak Leaf's products to Niagara Chocolates. At the hearing, Mr. Terranova also testified that he performed substantial services related to Oak Leaf from his office in New York, that Oak Leaf had several employees performing work in New York, and that Niagara Chocolates performed third-party warehouse storage and distribution services for Oak Leaf in 2001.

The Tribunal Decision. Agreeing with the ALJ, the Tax Appeals Tribunal found that Mr. Terranova had failed to prove by clear and convincing evidence that he had given up his New York State domicile and acquired a domicile in Florida. In particular, the Tribunal noted that active business ties to New York have been considered an indication of a failure to abandon a New York domicile. *See* *Matter of Kartiganer v. Koenig*, 194 A.D. 2d 879 (3d Dep't 1993). The record showed that Mr. Terranova had worked very few days in Florida as compared to the number of days he had worked in New York. Additionally, the Tribunal relied on the Department's regulations, which provide that where an individual has more than one home, the length of time customarily spent at each location is an important factor in determining domicile. *See* 20 NYCRR 105.20(d)(4). Thus, even though it agreed that Mr. Terranova "had a number of connections with Florida," the Tribunal found he failed to prove that he had changed his domicile during the years in question.

The Tribunal also rejected Mr. Terranova's argument that Oak Leaf was subject to corporation franchise tax and, therefore, the income he received from Oak Leaf in 2001 should be subtracted from his federal adjusted gross income under N.Y. Tax Law § 612(c)(22). The Tribunal concluded that the documentation provided by Mr. Terranova to support the fact that Niagara Chocolates provided storage and distribution services to Oak Leaf was inadequate, because the invoices were ambiguous and only covered a very limited number of transactions over a short period of time. Moreover, in the absence of corroborating documentary evidence, Mr. Terranova's assertions were not enough to prove that Oak Leaf maintained an office at Niagara Chocolates' facilities in New York, the amount of Oak Leaf's New York sales, or that Oak Leaf had employees performing work in New York. Therefore, Mr. Terranova was required to include the Schedule K-1 income from Oak Leaf in his New York adjusted gross income.

Additional Insights. For purposes of determining an individual's status as a resident of New York, a "domicile" is defined as the place that an individual intends to be his or her permanent home—that is, the place to which the individual intends to return whenever the individual may be absent. A domicile is presumed to continue until a new domicile is established. Despite establishing some of the indicia of a new domicile in Florida, such as the construction of a new home, Mr. Terranova failed to overcome the presumption and establish that he had severed his ties with his New York domicile.

With regard to the determination that Oak Leaf was not subject to corporation franchise tax, the *Terranova* decision may appear to be helpful to corporations disputing a nexus determination by New York State. However, it should be kept in mind that neither the ALJ nor the Tribunal determined that storage of inventory in New York, coupled with services of employees in New York and substantial New York sales conducted by brokers in New York, do not constitute doing business in New York. Rather, the ALJ and the Tribunal determined that Mr. Terranova had not provided adequate evidence to prove that Oak Leaf actually stored inventory in New York, used the services of employees in New York, or made substantial sales to New York. Thus, *Terranova* does not chart any new territory for what constitutes doing business in New York, since the decision turns entirely on a failure of proof.

Custom Business Analytics Reports Are Not Subject to Sales Tax

By Kara M. Kraman

The Department of Taxation and Finance has ruled that the sale of customized business analytics reports prepared using the customer's own data is not subject to New York State sales or use tax. *Advisory Opinion*, TSB-A-12(24)S (N.Y.S. Dep't of Taxation & Fin., Sept. 27, 2012). The Department concluded that the information was personal and individual in nature, and included only a *de minimis* amount of publicly available data. The Department also ruled that the customer's limited use of the seller's self-created software was part of the overall information service being provided, and was not itself subject to sales tax.

The seller is an Australian company that provides customized business analytics reports to its customers over the Internet. Those reports are prepared by gathering data from a customer's own payroll, human resources, and other business systems. At the customer's request, the seller, at no additional charge, includes a *de minimis* amount of data from public sources, such as average industry statistics, so that the customer can compare its own data with a benchmark. The seller uses its own self-written proprietary software to prepare the reports. The seller has no offices in New York State, and its proprietary software was never transferred into New York.

In general, services consisting of "compiling or analyzing information of any kind or nature and furnishing reports thereof to other persons" are subject to sales under Tax Law § 1105(c)(1). However, § 1105(c)(1) contains an exclusion from the sales tax for "the furnishing of information which is personal or individual in nature and which is not or may not be substantially incorporated in reports furnished to other persons. . . ." At issue was the taxability of the information services and related software.

The Department concluded that although the gathering of data from its customers' data systems, the mapping of that data, and the use of that data to create customizable reports constituted a taxable information service under Tax Law § 1105(c)(1), the seller's information services were personal and individual to the customer, and the seller could not furnish the reports to anyone else. Accordingly, the Department ruled that the information services fell under the exclusion from sales tax for personal information not furnished to other persons. The Department also noted that, so long as the amount of public benchmarking statistics in some of the reports was *de minimis,* it would not cause the seller to lose the exclusion. However, if it was more than *de minimis*, then the entire information service would be taxable.

The Department also addressed whether the seller's own use of its proprietary software to pull, integrate, and analyze data from its customers' systems was subject to sales or use tax, and concluded that such use was not. First, pursuant to Tax Law § 1110(a)(B), the seller's use of its own specialized software was not subject to tax because it wrote the software itself. The Department noted that, although the software was not sold to the seller's customers, the ability of New York customers to customize their reports using the software had some of attributes of use of the software in New York, and therefore the transaction could be considered a sale subject to tax. However, the Department concluded that because the customer's use of the software was limited to parameters set by the seller, and was a single aspect of a more comprehensive service that was integrally related to the overall service being provided, the transaction constituted the sale of an information service subject to the exclusion from tax and not the taxable sale of computer software.

Additional Insights. The Advisory Opinion is noteworthy because the Department found that the use of the seller's software was not a taxable sale, in part because the use was integrally related to the overall service provided by the seller, and was limited. This result seems correct and in keeping with the general rule that a small and incidental part of a service transaction that is integrally related to the overall service being provided will not be taxed separately and apart from the service transaction itself.

Insights in Brief

Admission Charges at Adult Juice Bar Are Subject to Sales Tax

The New York State Court of Appeals, in a 4-3 decision, held that general admission charges and charges for admission to private performance rooms at an adult juice bar were subject to sales tax as admission charges to places of amusement, and not excluded as charges for musical arts performances or choreographed performances. *Matter of 677 New Loudon Corp. v. State of New York Tax Appeals Tribunal*, 2012 NY Slip Op. 7046 (N.Y. Ct. App., Oct. 23, 2012). The majority affirmed the decisions below that the juice bar had failed to carry its burden of proof to show the dances qualified as choreographed performances, because its expert's opinion was not based on personal knowledge or actual observation of the dances in question. The three judges who dissented, including the chief judge, concluded that there was "not the slightest doubt" that the charges in question were for dance performances, and that the majority's decision simply found the performances not sufficiently "'cultural and artistic,'" thereby engaging in discrimination based on content.

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Insights in Brief

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Protective Claims for Refund of Transportation Mobility Tax

As reported in the September 2012 issue of *New York Tax Insights*, a Nassau County Supreme Court judge has declared the Metropolitan Commuter Transportation District Mobility Tax unconstitutional, and the decision is on appeal. While taxpayers remain required to pay the tax, the Department of Taxation and Finance has announced a procedure to allow the filing of protective claims for refund. Claims may be filed through an Online Service account, by completing an electronic form, or by calling (518) 485-2392, and must be filed by November 2, 2012, for payments made on or before November 2, 2009 by employers, or by April 30, 2013, for self-employed individuals.

Design Images Delivered Electronically Are Not Subject to Sales Tax

The Department of Taxation and Finance has issued advice that the sale of patent drawings, prepared as part of patent applications or litigation presentations, and delivered electronically as PDF files, is not subject to sales tax. *Advisory Opinion*, TSB-A-12(23)S, (N.Y.S. Dep't of Taxation & Fin. Sept. 20, 2012). The Department distinguished the drawings at issue from patent drawings delivered by mail as paper printouts, which had previously been held to constitute tangible personal property and found subject to sales tax in *Advisory Opinion*, TSB-A-97(48)S (Dep't of Taxation & Fin. July 23, 1997), and determined that the sale of drawings delivered "solely electronically" with no tangible format did not constitute sales of tangible personal property, and was therefore not subject to sales tax. This is consistent with New York's general approach to the sale of other electronically delivered products, such as e-books.

Tribunal Reverses ALJ Order Dismissing Petition as Untimely and Remands for Further Facts Regarding Proper Mailing Address

The Tax Appeals Tribunal reversed an Administrative Law Judge's order dismissing a petition as untimely, and remanded the case to the Division of Tax Appeals to determine whether a conciliation default order was mailed to the taxpayer's correct mailing address. The Tribunal was unwilling to rely on the Department's mail-tracking system printout as proof of proper mailing, because it was dated after the filing of the petition, and listed the incorrect amount of tax due. *Matter of Lawrence Zigerelli*, DTA No. 824237 (N.Y.S. Tax App. Trib., Sept. 20, 2012).