MOFO
NEW YORK TAX INSIGHTS

Volume 7, Issue 1, January 2016

IN THIS ISSUE

The Top 10 New York Tax Highlights of 2015
Page 1

"Real Estate Professional" Permitted Use of Rental Losses
Page 4

Sales Tax Refund Denied for Failure of Vendor to First Refund Tax to Customers
Page 6

State Issues Guidance on the Impact of Corporate Tax Reform on S Corporations and Their Shareholders
Page 6

State Issues Taxpayer-Friendly Guidance Applying Hotel Sales Tax Laws
Page 7

Insights in Brief
Page 9

THE TOP 10 NEW YORK TAX HIGHLIGHTS OF 2015

By Irwin M. Slomka

This past year turned out to be another eventful one in New York taxation. We continue our tradition and present our list of the Top 10 New York tax highlights of 2015.

1. **New York City enacts corporate tax reform legislation.** Belatedly but prudently, New York City substantially conformed its corporate tax to the New York State corporate tax reform legislation. Effective for tax years beginning on or after January 1, 2015, a new Subchapter 3-A tax is now imposed on both bank and non-bank C corporations. 2015–2016 New York State Budget (S. 4610A, A.6721A and S. 2009B, A. 3009B). The new law adopts market-based sourcing and imposes mandatory water's edge unitary combined reporting but, unlike the State tax, does not include an economic nexus provision. The City chose to retain the general corporation tax ("GCT") solely to apply to S corporations, while the City conducted a study on how all pass-through entities (S corporations, LLCs and partnerships) should be taxed. As of this writing, the results of the City's study have not been published, but it does not appear that the City will propose any pass-through entity legislation in the upcoming legislative session, which means the GCT will remain on the books for at least another year for S corporations.

2. **Court of Appeals rejects Constitutional challenges to State taxation of gain from sale of S corporation stock.** In two decisions, *Burton v. New York State Department of Taxation and Finance, et al.*, 25 N.Y.3d 732 (2015) and *Caprio v. New York State Department of Taxation and Finance, et al.*, 25 N.Y. 3d 744 (2015), the New York State Court of Appeals rejected separate challenges to the validity of a 2010 statutory amendment to Tax Law § 632(a)(2), made retroactive to tax years beginning after 2006. That legislation provided that gain recognized by a nonresident shareholder of an S corporation relating to the distribution of an installment obligation or from a stock sale for which an IRC § 338(h)(10) election was made would be considered New York source income of the nonresident shareholder, based on the S corporation's apportionment percentage. In *Burton*, the court rejected the taxpayer's claim that the law violated the New York State Constitution, which prohibits the taxation of income from intangibles unless the intangibles are used in the conduct of a trade or business in the State. In *Caprio*, the court

continued on page 2

overturned an Appellate Division decision in favor of the taxpayer, and in doing so rejected the taxpayer's claim that retroactive application of the 2010 amendments to 2007 was unconstitutional under the Due Process Clause.

3. **Court of Appeals allows *qui tam* suit against Sprint Nextel to move forward, but Vanguard successfully obtains dismissal of action brought by a former in-house lawyer.** The 2010 legislative expansion of the New York False Claims Act, permitting private "whistleblower" *qui tam* State tax actions, remains one of the most ill-advised New York State tax enactments in memory. *Qui tam* lawsuits continued to be brought, some unsealed (as recently disclosed in a more than $2 billion action brought against Citigroup, Inc. by an Indiana University professor), but others undoubtedly remain sealed and are not yet known to the public. In 2015, in a setback for taxpayers, the Court of Appeals rejected a motion made by Sprint Nextel to dismiss a more than $100 million *qui tam* action brought by New York State Attorney General Schneiderman, holding that the AG's complaint sufficiently set forth a cause of action, permitting the case to proceed to discovery. *People of the State of New York et al. v. Sprint Nextel Corp., et al.*, No. 127, 2015 NY Slip Op. 07574 (Oct. 20, 2015).

   Meanwhile, a New York County Supreme Court judge dismissed a *qui tam* suit against the Vanguard Group in which the AG had declined to intervene, brought by a former in-house counsel to Vanguard, on the grounds that the former counsel violated rules of attorney professional conduct in bringing the action. *State of New York ex rel. David Danon v. Vanguard Group, Inc., et al.*, No. 100711/13, 2015 NY Slip Op. 32213(U) (Nov. 13, 2015). Unfortunately, no meaningful initiatives surfaced in 2015 to repeal or scale back the controversial 2010 *qui tam* legislation.

4. **City Tribunal overturns ALJ decision, rejects McGraw-Hill First Amendment claim for audience factor apportionment.** The New York City Tax Appeals Tribunal reversed an Administrative Law Judge decision, and held that McGraw-Hill did not have a First Amendment right (freedom of the press) to source its Standard & Poor's credit rating receipts for New York City corporate tax purposes using an "audience-based" methodology similar to that available to publishers and broadcasters. The City Tribunal also held that the credit rating receipts were from the performance of services, sourced to where the services are performed, and were not "other business receipts" sourced to where the receipts are "earned." *Matter of The McGraw Hill Companies, Inc.*, TAT(H) 10-19(GC) *et al.* (N.Y.C. Tax App. Trib., Oct. 28, 2015). It is expected that McGraw-Hill will appeal the City Tribunal decision to the New York courts.

5. **State Tribunal permits corporate taxpayer to file combined returns despite the absence of substantial intercorporate transactions.** In another loss by the State Tax Department regarding pre-2015 permissive combination under Article 9-A, the State Tribunal reversed an Administrative Law Judge decision, and held that SunGard Capital Corp. could file on a combined basis for 2005 and 2006 based on a showing of a unitary business relationship and proof of actual distortion, despite the absence of substantial intercorporate transactions. *Matter of SunGard Capital Corp., et al.*, DTA Nos. 823631, *et al.* (N.Y.S. Tax App. Trib., May 19, 2015).

   One important aspect of the decision involved the unitary business requirement — which continues under corporate tax reform — and the Tribunal's conclusion that companies in "complementary businesses" can be unitary, even though conducting different lines of business. The Tribunal also found that a centralized cash management system was evidence of a unitary business, as was the flow of value resulting from providing intercorporate services without charge. As for the pre-2015 distortion requirement for combination, the Tribunal noted that the same factors indicative of a unitary business relationship may also give rise to distortion. The decision may provide further support for the Department to resolve its existing pipeline of de-combination audits.

6. **New York State does not appeal the *Expedia* decision, which held that receipts from providing online travel reservations are sourced to where services were performed, and not to the customer location.** To the surprise of many, the State Tax Department decided not to appeal a February 2015 ALJ decision in favor of Expedia, which held that receipts from providing online travel reservations were from the performance of services under Article 9-A and sourced to where the services were performed. *Matter of Expedia, Inc.*, DTA Nos. 825025 & 825026 (N.Y.S. Div. of Tax App., Feb. 5, 2015). The ALJ had rejected the Department's position that the receipts were "other business receipts," sourced to where "earned," which the Department claimed was at the location of the customer.

continued on page 3

Several years ago, the Department abruptly changed its policy – through an Advisory Opinion that dealt with credit card processing services — by treating receipts from services provided "electronically," involving what the Department described as minimal human involvement, as "other business receipts" sourced to the customer's location, rather than receipts from services. By not appealing, the Department insured that the *Expedia* ALJ decision remains non-precedential. The sourcing of receipts from various forms of "electronically" provided services has been a frequent source of controversy in Article 9-A audits, and it is hoped that the ALJ decision in *Expedia*, while not precedential, will lead to the informal resolution of audits involving the sourcing of "electronically" furnished services under the pre-2015 law.

7. **State Tax Department begins to release corporate tax reform guidance.** As expected given the vast changes under corporate tax reform, this past year the State Tax Department began releasing policy statements, including drafts of regulations, interpreting the new law. The policies were released through a variety of pronouncements, including Technical Memoranda, Q&As appearing on the Department's web site, and, in at least one instance, an Advisory Opinion. The most comprehensive policy pronouncements were draft regulations released for comment in late 2015 involving nexus (including economic nexus and nexus through partnerships and LLCs) and the sourcing of receipts from digital products and other business receipts.

   As we went to press, the State also began releasing its 2015 Article 9-A tax return forms, and issued a Technical Memorandum regarding interest expense attribution. It is anticipated that further draft regulations will be released in 2016, including regulations interpreting the new water's edge unitary combination regime, as well as guidance involving the calculation of prior net operating losses from the pre-2015 Article 9-A.

8. **State Tribunal upholds partial liability of LLC members for LLC's sales tax liability.** The State Tax Tribunal sustained an ALJ decision holding that a member of an LLC who owned a minority interest in the LLC was liable for a portion of the LLC's sales and use tax liability. *Matter of Eugene Boissiere and Jason Krystal*, DTA No. 824467, *et al.* (N.Y.S. Tax App. Trib., July 28, 2015). The Tribunal rejected the taxpayers' argument that any strict liability of an LLC member — even liability limited to the member's percentage interest in the LLC as set forth in TSB-M-11(17)S — violated the New York State Limited Liability Law. It instead held that the plain language of the Tax Law provided for full member liability, and that the Department's policy of limiting liability in certain instances ameliorated any "harsh consequences" that might warrant a departure from the literal language of the Tax Law. The Tribunal's decision was not appealed, and thus the Department's policy on LLC member liability has survived this legal challenge.

9. **State Tax Department does not appeal the ALJ decision holding that a "flat sum settlement" with the IRS is not a reportable federal change for State income tax purposes.** In what could be an issue of first impression in New York, in April 2015 a State ALJ held that an individual's "flat sum settlement" with the Internal Revenue Service did not constitute a change in the taxpayer's federal taxable income that triggered a New York State reporting requirement, and therefore the IRS settlement did not extend the statute of limitations for assessment. *Matter of Bentley Blum*, DTA No. 825455 (N.Y.S. Div. of Tax App., Apr. 16, 2015). Although the issue of whether a flat sum settlement — whether for individuals or corporations — must be reported to the State or City and thus opens an otherwise closed tax year is a significant one, the State Tax Department did not file an appeal. The decision is not precedential, and the Department has not indicated whether it will acquiesce to the result in *Bentley Blum*.

10. **First New York City Taxpayer Advocate is appointed.** In July 2015, New York City appointed its first Taxpayer Advocate, Diana Leyden, and created the Office of the Taxpayer Advocate to address both specific taxpayer problems and systemic problems involving taxes administered by the New York City Department of Finance. The office is generally modeled on the Taxpayer Advocate offices at the Internal Revenue Service and State Tax Department. One of the New York City Taxpayer Advocate's first actions was to develop a completely revamped "NYC Taxpayer Bill of Rights." In 2016, the Taxpayer Advocate is expected to issue reports to the Commissioner and to the New York City Council that will, among other things, identify systemic issues and make recommendations for possible procedural or legislative changes.

continued on page 4

"REAL ESTATE PROFESSIONAL" PERMITTED USE OF RENTAL LOSSES

By Hollis L. Hyans

A New York State Administrative Law Judge has found that a New York resident met the criteria for a "real estate professional" and therefore could offset passive rental real estate losses against nonpassive income. *Matter of Claudel Chery*, DTA No. 825699 (N.Y.S. Div. of Tax App., Dec. 3, 2015).

Facts. Mr. Chery, the petitioner, claimed total rental losses of over $87,000, arising from two properties located in Brooklyn and Middletown. On the Brooklyn property, he reported rents of $64,650 and expenses of over $107,000; on the Middletown property, rents in the amount of $18,000 and expenses of approximately $63,000. During 2008, Mr. Chery resided in a condominium in the Bronx that he was also actively trying to rent out in order to move in with his wife, whom he married in 2008. Mr. Chery worked full time as a postal inspector and worked on his rental properties when not at his regular job, including performing repairs and maintenance and handling all management functions. Although he had been involved in real estate ownership and rental since 2003, in 2008 Mr. Chery first classified himself as a real estate professional and treated all his interests in rental real estate business activities as a single activity, including the required statements with his 2008 personal income tax return.

On audit, the Department of Taxation and Finance requested records regarding the properties, as well as detailed records of services performed and hours attributable to those services. Mr. Chery provided all the records, including a contemporaneously prepared vehicle log with 559 entries for 2008. Although the vehicle log had been created with the intention of tracking mileage associated with business use of the vehicle, it also included explanations of the purposes of all the rental-related tasks listed, travel locations, miles traveled, hours spent, and other information. Based on the vehicle log, Mr. Chery calculated that he spent 1,872 hours on rental-related activities in 2008. He also provided a contemporaneously prepared electronic calendar and appointment book, with entries on 286 days, that largely correlated to the vehicle log entries, but also recorded additional time for tasks that had not involved travel, ranging from 10 to 20 hours a month.

Mr. Chery also spent time consulting on real estate projects, conducting business under the name CLC Property Management ("CLC"), for which he maintained separate books and records, including a business bank and credit card account, a separate vehicle, tools, a website, and space used exclusively for storage of supplies for the CLC business. He used as his principal site for his rental businesses a home office at his Bronx address, keeping records of trips between that office and his Brooklyn or Middletown properties.

After review of the records, the Department stated that Mr. Chery identified 2,047 hours spent as a U.S. postal inspector, and only 1,872 hours spent on rental properties, and that some of those 1,872 hours did not count, claiming that, for example, some of the work was done before Mr. Chery actually owned the properties, was spent on work not customarily done by an owner, or was for a property that was not leased at the time. Mr. Chery responded with a detailed written response, providing specific responses to the Department's challenges, including details on his experiences repairing properties since his childhood. The Department nonetheless issued a Notice of Deficiency in April 2012. Mr. Chery continued to submit additional supporting information, and in response, for the first time, after the Notice had already been issued, the auditor characterized additional hours identified by Mr. Chery to be hours spent on a "hobby."

The Dispute. New York follows federal law on passive rental losses. Section 469(a) of the Internal Revenue Code generally disallows passive activity losses, which are defined as the excess of the aggregate losses from all passive activities over aggregate income from all passive activities. A passive activity is any trade or business in which the taxpayer does not materially participate, under IRC § 469(c)(1), and a rental activity is generally treated as a *per se* passive activity whether or not the taxpayer materially participates. IRC § 469(c)(2), (4). However, there is an exception for rental activities of "real estate professionals," which are treated as a trade or business, subject to the "material participation" requirements of § 469(c)(1) and Treas. Reg. § 1.469-5T(e)(1). A taxpayer may qualify as a real estate professional if (1) more than one half of the personal services performed in all trades or business by the taxpayer are performed in real property trades or businesses in which the taxpayer materially participates; and (2) the taxpayer performs more than 750 hours of services in real property trades or business in which the taxpayer materially participates. IRC § 469(c)(7)(B)(i), (ii). A taxpayer "materially participates" if he or she works on a regular, continuous and substantial basis, and a taxpayer is permitted to establish participation "by any reasonable means." Treas. Reg. § 1.469-5T(f)(4).

continued on page 5

The only issue in dispute was whether Mr. Chery had performed more than one half of his personal services during 2008 in real property trades or businesses, which meant that he had to spend more than the 2,047 hours that the parties agreed he spent as a U.S. postal inspector. Material participation was not disputed by the Department.

The ALJ agreed that Mr. Chery was entitled to be treated as a real estate professional. She found that Mr. Chery participated in his rental activities on a "regular, continuous and substantial basis," hired no help, and was "clearly involved in the day-to-day management of his rental property in every aspect."

ALJ Determination. The ALJ agreed that Mr. Chery was entitled to be treated as a real estate professional. She found that Mr. Chery participated in his rental activities on a "regular, continuous and substantial basis," hired no help, and was "clearly involved in the day-to-day management of his rental property in every aspect." She relied on the "meticulous contemporaneous vehicle log" he maintained, which the ALJ determined contained "more than sufficient supplemental documentation" of Mr. Chery's hours of participation. She rejected the Department's challenge to the time Mr. Chery spent traveling to his properties, finding that his travel time was "unequivocally" an "integral" part of the rental property operations. The ALJ distinguished Mr. Chery's evidence from that found insufficient in *Mowafi v. Commissioner of Inernal Revenue*, T.C. Memo 2001-111 (2011), where the taxpayer relied primarily on trial testimony and noncontemporaneous logs prepared in connection with a tax audit. Mr. Chery had submitted his contemporaneous vehicle log, an electronic calendar, and a contemporaneous compilation of miles driven, expenses and hours spent, and established that many tasks listed on his calendar entries did not require a trip and therefore did not appear in the vehicle log.

The ALJ therefore found that 180 hours identified in the calendar should have been added to the vehicle log hours of 1,872, totaling 2,052 hours, alone sufficient to exceed the 2,047 hours spent on the postal service job. However, the ALJ also found that the 289 hours he spent on his real estate consulting business, CLC, should be included, despite Mr. Chery's having failed to properly set forth his CLC activities on a federal Schedule C. She concluded that Mr. Chery's real estate consulting activity for CLC should be treated together with his rental activities for the properties he owned as a single activity, and that the vehicle log hours of 1,872, the 180 non-vehicle log hours, and the 289 CLC hours came to well more than the 2,047 hours spent on the postal service job, qualifying Mr. Chery as a real estate professional and allowing him to claim rental losses without limitation.

Additional Insights.

The IRC contains strict requirements that an individual must meet before being able to claim rental loss deductions. In 2011, a report prepared by the Treasury Inspector General for Tax Administration evaluated the IRS's audits of individual tax returns with rental real estate activity and recommended increased scrutiny, in the light of public reports of substantial lack of compliance with the rules. There is no indication in the *Chery* decision that the IRS had audited the taxpayer's returns, but the facts recited in the decision make clear that the Department, as well as the IRS, is carefully inspecting returns claiming passive rental losses.

Here, the ALJ stressed several times that extensive contemporaneous records were relied upon, and while the federal regulations expressly state that contemporaneous records are not required if the extent of the taxpayer's participation is established by "other reasonable means," Treas. Reg. § 1.469-5T(f)(4), there can be no doubt that such records weighed heavily in the taxpayer's favor. Also, the ALJ described Mr. Chery as a "well-educated, hard working young man" who "approached the management and operation of his rental properties from a posture of sophistication and dedication" and noted that his records "reflected a high level of conscientiousness." It seems clear that the credibility of Mr. Chery as a witness played a large part in his convincing the ALJ of the basis for his position, including the fact that he apparently worked more hours on his real estate ventures than on his day job, for a total number of hours that left little time remaining in the day for anything else.

continued on page 6

SALES TAX REFUND DENIED FOR FAILURE OF VENDOR TO FIRST REFUND TAX TO CUSTOMERS

By Hollis L. Hyans

A New York State Administrative Law Judge has held that a car dealership could not obtain a refund of sales tax paid on sales of cars and extended warranties because it had failed to first refund the amounts to its customers. *Matter of Stamford Subaru, LLC*, DTA No. 826071 (N.Y.S. Div. of Tax App., Dec. 10, 2015). The ALJ did not agree with the dealership's claims that it, rather than its customers, had borne the incidence of the tax.

Facts. Stamford Subaru, the dealership, operated in Stamford, Connecticut, approximately three miles from the New York border, and frequently sold automobiles and extended warranties to New York State residents. It collected sales tax on those sales and remitted the tax to New York State. After an audit by the Connecticut Department of Revenue, the dealership was advised that sales tax was due to Connecticut on sales of all extended warranties sold in Connecticut. Stamford Subaru paid the amount due to Connecticut, at the same rate, and then sought a refund from New York State for the amounts it had collected from its New York customers on the sales of extended warranties. Stamford Subaru argued that it had "in essence" refunded the collected sales tax and then recharged the tax, at the same rate applicable in both states, which was remitted to Connecticut.

ALJ Decision. The ALJ found that Stamford Subaru had failed to fulfill the requirements of Tax Law § 1139(a), which mandates that, in order to be eligible for a refund of taxes erroneously collected from customers, vendors must demonstrate that the tax was first repaid to the customers. Here, Stamford Subaru was arguing that it had paid the sales tax directly to New York and therefore had no obligation to refund anything to its customers, asserting that 75% of the sales tax it paid to New York "came from its own pocket," because that portion was actually owed to Connecticut and paid to that state at a later date. The ALJ rejected this argument, finding that all the sales tax was originally collected from the customers on both purchase of vehicles and purchase of extended warranties. Therefore, the ALJ found that Stamford Subaru had to repay its customers before it was entitled to a refund.

Additional Insights.

It is not clear exactly what Stamford Subaru could have done to qualify for a refund under the ALJ's analysis. There is no doubt that, under New York law and the law of many other states, sales tax collected from customers must be refunded to those customers before a refund can be claimed from the taxing authority and also no doubt that, initially at least, Stamford Subaru collected the tax from customers and remitted it to New York State. After learning that the tax should have been remitted instead to Connecticut, Stamford Subaru then paid tax to Connecticut, in the same amount, since the rates were the same, but not collected from anyone. There would have been no reason and no logic in refunding the New York sales tax originally collected from customers, and then simultaneously asking the same customers to immediately remit the same exact amount back to Stamford Subaru as Connecticut sales tax so that it could send the money instead to Connecticut. Since the tax was collected just once from customers but paid twice to different jurisdictions, and given the general rule that money is fungible, another way of looking at the facts would have been to say that the tax collected from the customers was actually paid to Connecticut, allowing a refund to Stamford Subaru and avoiding a windfall to New York State in the form of tax to which it was never entitled.

STATE ISSUES GUIDANCE ON THE IMPACT OF CORPORATE TAX REFORM ON S CORPORATIONS AND THEIR SHAREHOLDERS

By Kara M. Kraman

The New York State Department of Taxation and Finance has issued guidance regarding the impact of the recent corporate tax reform legislation on S corporations and their nonresident and part-year resident shareholders. *Technical Memorandum*, "Impact of New York State Corporate Tax Reform on New York S Corporations and their Nonresident and Part-Year Resident Shareholders," TSB-M-15(7)C, (6)I (N.Y.S. Dep't of Taxation & Fin., Dec. 1, 2015).

In order to obtain New York S corporation pass-through treatment, all of an S corporation's shareholders, including nonresidents, must consent to be taxed on their New York source income from the S corporation. As a result, all of the New York S corporation's apportioned income earned by nonresident shareholders is subject

continued on page 7

to New York State personal income tax under Article 22. Pursuant to Tax Law § 631, nonresident shareholders must include in their New York source income their pro rata share of the S corporation's income, loss, and deductions that are derived or connected with New York sources as determined under Tax Law § 632. Tax Law § 632 provides, in turn, that nonresident shareholders in a New York S corporation determine their New York source income from the S corporation using the allocation rules under Article 9-A, even if those items are not included in a corporation's entire net income under Article 9-A.

> [F]or New York S corporations, all of a nonresident shareholder's share of S corporation items must be sourced to New York using the New York S corporation's business apportionment factor, regardless of whether a portion of those S corporation items are treated as exempt...for Article 9-A purposes.

Under the recent corporate tax reform legislation (Part A of Chapter 59 of the Laws of 2014 and Part T of Chapter 59 of the Laws of 2015), the Article 9-A apportionment rules were substantially amended. Whereas under the previous rules an Article 9-A taxpayer's business income was apportioned using its business allocation percentage. and its investment income was apportioned using its investment allocation percentage, under the new law all of an Article 9-A taxpayer's income is apportioned to New York using its business apportionment factor, which reflects a corporation's New York State market-based receipts. Tax Law § 210-A. Qualifying investment income and so-called "other exempt income" are now exempt from tax under Article 9-A, and there is no longer an investment allocation percentage.

As a result of these changes, for tax years beginning on or after January 1, 2015, the Technical Memorandum provides that for New York S corporations, all of a nonresident shareholder's share of S corporation items must be sourced to New York using the New York S corporation's business apportionment factor, regardless of whether a portion of those S corporation items are treated as exempt investment income or "other exempt income" for Article 9-A purposes. This is the result because there is no exemption for investment income or "other exempt income" under the personal income tax, and the electing shareholders of a New York S corporation are considered to have affirmatively consented to being taxed on such income.

STATE ISSUES TAXPAYER-FRIENDLY GUIDANCE APPLYING HOTEL SALES TAX LAWS

By Michael J. Hilkin

The New York State Department of Taxation and Finance released two Advisory Opinions analyzing the sales tax imposed on charges for hotel occupancy under Tax Law § 1105(e). One Advisory Opinion concluded that the Petitioner's rentals of furnished one-family dwellings for periods as short as two days were not subject to sales tax because the units could not be classified as "rooms in a hotel." *Advisory Opinion*, TSB-A-15(38)S (N.Y.S. Dep't of Taxation & Fin., Nov. 13, 2015). The other Advisory Opinion concluded that the Petitioners were not "room remarketers" and thus were not subject to New York sales tax collection responsibility when they facilitated the online purchase and reservation of hotel rooms by third-party customers. *Advisory Opinion*, TSB-A-15(43)S (N.Y.S. Dep't of Taxation & Fin., Nov. 13, 2015).

Advisory Opinion on Rental Units

This Advisory Opinion involved a Petitioner that rented out eight furnished units intended for single-family occupancy in New York. Five of the units were one-family dwellings owned by the Petitioner, two were condominium units leased to the Petitioner, and one other unit was an apartment managed by the Petitioner on behalf of its owner. In furnishing the units, the Petitioner provided linens but did not change the linens during a stay. The Petitioner did not provide maid service, food service, concierge service, entertainment, planned activities, or transportation service in relation to the unit rentals. The units were rented for a minimum of two nights and could be rented for periods of a month or longer.

The Department concluded that none of the amounts collected as rent on any of the units were subject to New York sales tax imposed on hotel occupancy charges. As stated in the Opinion, the Tax Law defines a "hotel" for sales tax purposes as "[a] building or portion of it which is regularly used and kept open as such for the lodging of guests." Tax Law § 1101(c)(1). The regulations identify

continued on page 8

four factors for determining whether a building (or portion of a building) meets the definition of "hotel":
(i) whether sleeping accommodations are provided for the lodging of paying occupants on a regular basis;
(ii) whether typical occupants are transients or travelers;
(iii) whether housekeeping, linen, or other customary hotel services are provided for occupants; and
(iv) whether the relationship between the operator of the establishment and the occupant is that of an innkeeper and a guest, not that of a landlord and tenant.
20 N.Y.C.R.R. § 527.9(b)(1). Further, the Department emphasized that "sales tax is not imposed on rentals of real property," and that a furnished living unit limited to a single-family occupancy is not subject to the sales tax on hotel occupancy "provided no housekeeping, food, or other common hotel services, such as entertainment or planned activities, are provided by the lessor." As no such services were provided, the Department concluded that the units could not be classified as "rooms in a hotel," and sales tax is not due on the charges to occupants.

The four-factor test for determining when a building or portion of a building will be classified as a "hotel" was added to the Department's regulations in 2009, [and] this Advisory Opinion...show[s] how the Department will apply such regulatory language.

Advisory Opinion Concerning Facilitation of Hotel Room Bookings

This Opinion involved two Petitioners that provided the service of booking hotel rooms for travelers in New York and elsewhere. Neither Petitioner maintained an inventory of rooms on its own behalf or directly purchased hotel rooms in New York for resale. The first Petitioner entered into license agreements with hotel operators to provide information technology and advertising services, including listing hotel rooms on its website. The second Petitioner entered into contracts with hotel operators to act as a booking agent.

Both Petitioners collected a non-refundable deposit calculated as a fixed percentage of the reservation — typically 10 percent of the total value of the reservation — at the time of a booking by a traveler. Such deposits were kept by the Petitioners in exchange for their services. For a limited period, the first Petitioner also collected a flat reservation fee from travelers, which either was collected on a transaction-by-transaction basis or was waived for travelers who paid an annual membership fee. Neither Petitioner set the hotel room charges, which were instead set by the respective hotel operators. All charges (other than the deposit fee) associated with the traveler's stay at a hotel were paid directly to the hotel operators. The Petitioners had no further obligation after a room was booked (except with relation to the deposit fee if the traveler obtained cancellation protection), and travelers had to cancel a booked room by contacting the hotel operator directly.

The Department concluded that neither Petitioner was required to collect sales tax on the charges for a hotel room booked using the Petitioners' services. Under the Tax Law, sales tax collection responsibility is placed on "persons required to collect any tax." For purposes of the collection of sales tax on hotel occupancy charges, a "person required to collect tax" is defined to include "[a]ny person operating a hotel" and a "room remarketer." Tax Law § 1101(c)(4). A "room remarketer" is defined as "[a] person who reserves, arranges for, conveys, or furnishes occupancy . . . to an occupant for rent in an amount determined by the room remarketer." Tax Law § 1101(c)(8). Consistent with the statute, this Opinion highlighted an earlier Technical Memorandum stating that businesses akin to travel agencies that reserve rooms on behalf of customers but "do not have the right to determine the amount of rent that their customer pays for the room" are not room remarketers. *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). The Department ruled that the Petitioners were not hotel operators, and that the reservation fees they charged were not calculated in a manner constituting "determining" rent for purposes of the room remarketer definition. Therefore, the Petitioners were not required to collect sales tax on hotel occupancy charges — instead, only the hotel operator and the occupant were jointly liable for any sales tax due.

Additional Insights.

The Advisory Opinions provide valuable insight into how the Department will apply the 2009 and 2010 changes to New York tax statutes and regulations. The four-factor test for determining when a building or portion of a building will be classified as a "hotel" was added to the Department's regulations in 2009. This Advisory Opinion on rental units is one of the few opinions showing how the Department will apply such regulatory language, and it provides an example of the Department acknowledging that a rental of a dwelling space was not a "hotel." Further, the Tax Law was amended effective September 1, 2010, to require persons classified as "room remarketers"

continued on page 9

to collect sales tax on hotel occupancy charges. The Opinion dealing with facilitating room bookings reiterates that offering hotel reservations on behalf of a hotel will not make a person a "room remarketer" if such person does not have the power to determine the amount of the hotel's occupancy charge — even if such person conducts activities online. The activities of the Petitioners in this Opinion can be distinguished from the activities of companies like Expedia.com that pay hotels for rooms and then resell such rooms to travelers. While both Advisory Opinions explicitly state that they do not address the "hotel occupancy tax imposed and administered by a locality itself," the Advisory Opinions could be helpful in interpreting terms defined similarly for New York State sales tax and local hotel occupancy tax purposes. *See*, *e.g.*, the definition of "hotel" in Tax Law § 1101(c)(1) & N.Y.C. Admin. Code § 11-2501(5).

INSIGHTS IN BRIEF

Administrative Law Judge Holds That Payment Made in Settlement of Litigation Is a Capital Expenditure

An Administrative Law Judge has sustained for New York State personal income tax purposes a real property owner's treatment of a payment in settlement of litigation as a capital expenditure under Internal Revenue Code § 263, causing it to be includable in the owner's basis when calculating his gain from the sale of the real property, because the settlement payment was made in order to remove a claim on the real property. *Matter of Joseph Jeffries-El*, DTA No. 826103 (N.Y.S. Div. of Tax App., Dec. 10, 2015). The ALJ also held that the property owner's payment of mortgage interest and repayment of monetary advances were allowable as deductible business expenses because such expenses were "ordinary and necessary" expenses incurred in the property owner's business of property development. The Department had argued that the payments were neither bona fide capital expenditures nor deductible business expenses.

State Tribunal Affirms Use of Test Period Audit Methodology

The New York State Tax Appeals Tribunal has upheld the determination of an Administrative Law Judge that the Department properly utilized a test period audit methodology where the taxpayer had complete and adequate books and records, but had executed a valid consent to the use of a test period audit method. *Matter of Top Drawer Custom Cabinetry Corp.*, DTA No. 825588 (N.Y.S. Tax App. Trib., Nov. 19, 2015). The Tribunal also rejected the taxpayer's claim that it had subsequently revoked its consent to a test period, and held that since the Department had substantially completed a test period audit based on the executed waiver, the taxpayer was bound by its consent.

Property That Straddles the NYC Border Determined to be in Yonkers

The New York State Department of Taxation and Finance has issued an Advisory Opinion finding that a petitioner and his wife, who own and reside in a property that straddles the Bronx/Yonkers border, are residents of Yonkers subject to the Yonkers resident income tax surcharge, and are not subject to New York City personal income tax. *Advisory Opinion*, TSB-A-15(8)I (N.Y.S. Dep't of Taxation & Fin., Nov. 17, 2015). Although the front yard of the property is in Bronx County, that portion of the property is vacant residential land, while the residential building is located entirely on land in Yonkers and the petitioner and his wife do not work or maintain any residence in New York City. The Department assumes in its Advisory Opinion that the petitioner and his wife established the intent to be domiciled in Yonkers and, since they maintain a permanent place of abode in Yonkers, they meet the definition of Yonkers residents.

Tribunal Sustains "Responsible Person" Determination, Except for Period in Which Petitioner Was "Locked Out" of the Business

The New York State Tax Appeals Tribunal has affirmed, in substantial part, the decision of an Administrative Law Judge finding that an individual was a responsible person and could be held personally liable for sales and use tax due from two corporate entities operating donut shops. *Matter of Peter Pappas*, DTA Nos. 822124 & 822125 (N.Y.S. Tax App. Trib., Dec. 11, 2015). Although Mr. Pappas had no involvement in the daily operations of the donut shops, which were overseen by a friend of Mr. Pappas, Nicholas Papamichael, who had invited him to invest in the businesses, Mr. Pappas had signatory authority on the corporations' bank accounts and occasionally signed a corporate check or a tax return, which was sufficient for the Tribunal to sustain the finding of personal liability. However, the Tribunal also found that Mr. Pappas proved that by 2005, the second of two years in issue, he had been "locked out" of the businesses by Mr. Papamichael, and he signed no documents in 2005, so that he lacked the necessary authority to be considered a responsible officer for sales tax periods commencing in 2005.

continued on page 10

CHAMBERS USA 2015

- California: Tax
- Nationwide: Tax Controversy
- New York: Tax

LEGAL 500 US 2015

- Domestic Tax
- Nationwide: Tax Controversy

U.S. NEWS – BEST LAWYERS® BEST LAW FIRMS 2016

- Law Firm of the Year: Litigation – Tax
- National: Litigation – Tax (Tier 1)
- National: Tax Law (Tier 1)
- New York: Litigation – Tax (Tier 1)
- New York: Tax Law (Tier 1)
- Sacramento: Litigation – Tax (Tier 1)
- San Francisco: Litigation – Tax (Tier 1)
- San Francisco: Tax Law (Tier 1)
- Washington, D.C.: Tax Law (Tier 1)

LAW360

- 2013 Tax Practice Group of the Year

CHAMBERS USA 2015

"THEY DO A TERRIFIC JOB, THEY'RE VERY INFORMED AND REALISTIC."

CHAMBERS USA 2014

"THEY BRING A SUPERIOR DEGREE OF FLEXIBILITY AND EFFICIENCY."

LEGAL 500 2013

"ONE OF THE BEST NATIONAL FIRMS IN THE AREA OF STATE INCOME TAXATION."

CHAMBERS 2012

"MOFO HAS THE TOP STATE AND LOCAL TAX PRACTICE IN THE COUNTRY. THE LAWYERS KNOW THEIR SUBJECT MATTER AND ALWAYS GET MY COMPANY GREAT RESULTS."

MORRISON
FOERSTER

STATE + LOCAL TAX

WHAT SEPARATES US FROM THE REST?

OUR EXPERIENCE. We've been doing it longer, have more experience and published decisions, and have obtained a greater number of favorable settlements for our clients than the rest.

OUR TRACK RECORD OF PROVEN SUCCESS. We've successfully litigated matters in nearly every state, and have resolved the vast majority of matters without the necessity of trial.

OUR NATIONAL PERSPECTIVE. We approach state and local tax issues from a nationwide perspective, taking into account the similarities and differences of SALT systems throughout the United States.

OUR DEPTH. Our team is comprised of a unique blend of public and private backgrounds with experience spanning varied industries. We're nationally recognized as a leading practice for tax law and tax controversy by *Chambers*, *Legal 500* and *Law360*. In fact, we've been referred to as "one of the best national firms in the area of state income taxation" by *Legal 500 US* and were rated Law Firm of the Year for Litigation – Tax by the 2016 "Best Law Firms" Edition of *U.S. News & World Report – Best Lawyers*.

For more information about Morrison & Foerster's State + Local Tax Group, visit www.mofo.com/salt or contact Craig B. Fields at (212) 468-8193 or cfields@mofo.com.