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IN THIS ISSUE

Recent Unpublished NYC Department of Finance Letter Rulings

By Irwin M. Slomka

We have obtained under the Freedom of Information Law several Finance Letter Rulings of interest, most involving the New York City real property transfer tax, issued by the New York City Department of Finance. They constitute all letter rulings issued by the Department in 2015 and during the first half of 2016. None of these rulings currently appear on the Department's website. They are summarized below.

- **Transfer of realty by LLC owned by a nonprofit qualifies for exemption from the RPTT.** One of the more interesting real property transfer tax ("RPTT") letter rulings involved an educational organization exempt from federal income tax under IRC § 501(c)(3) that operates a museum in New York City and that occupies real property owned by a real estate holding limited liability company, which leased the real property to the organization. The transaction involved the sale of the real property by the LLC to a developer for cash, after which the developer would construct two condominium units on the property, one unit to house the educational organization, the other unit consisting of residential apartments to be sold or rented by the developer. Upon completion of the project, the developer would transfer the first unit either to the educational organization or to a new LLC owned by the organization.

  The Department ruled that the LLC's sale of the real property to the developer would qualify as an exempt transfer made by a nonprofit educational organization under Administrative Code § 11-2106(b)(2), even though the LLC is not itself a § 501(c)(3) organization. The Department concluded that had the educational organization sold the real property directly, the sale clearly would have qualified for exemption from RPTT, and since the sole purpose of the LLC was to own and hold the property on behalf of the organization, the Department concluded that the same result should apply. *Finance Letter Ruling*, FLR-15-4974 (N.Y.C. Dep't of Fin., May 23, 2016).

- **RPTT calculation of consideration for the sale of air rights.** In another RPTT letter ruling, the Department was asked how to calculate taxable consideration on a sale of air rights (including development rights) relating to Manhattan real property currently being used as a parking lot, which would be the site of a new building to be constructed by the purchaser. The purchaser paid

continued on page 2

the seller $15.2 million for the air rights, although the purchaser will also spend $978,000 to construct retail space that will be retained by the seller, who will reimburse the purchaser $500,000 toward those construction costs.

The Department ruled that the consideration is the $15.2 million paid to the seller for the air rights, plus the purchaser's construction costs for the retail space retained by the seller, less the seller's $500,000 contribution toward those costs. A quitclaim deed confirming that the seller will own only the retail portion of the new building, and another confirming title in the purchaser for the other portions of the building, both made without additional consideration, were found to be exempt from RPTT as mere changes in form of ownership under Administrative Code § 11-2106(b)(8). *Finance Letter Ruling*, FLR-15-4967 (N.Y.C. Dep't of Fin., Nov. 13, 2015).

- **RPTT rate on transfers of residences and individual co-op and condo apartments.** Most of the RPTT letter rulings address questions of whether the lower RPTT rate on sales of residential real property (including individual cooperative apartments and condominium units) (1.425% where the consideration is more than $500,000) or at the higher rate (2.625% where the consideration is more than $500,000) applies to the sale. The Department tends to take a flexible facts and circumstances approach regarding the applicable RPTT rate:

  - The sale by a trust of two Manhattan co-op apartment units that were physically connected through an internal hallway, and that were long occupied as a single apartment, qualified for the lower RPTT rate on sales of individual cooperative apartments. *Finance Letter Ruling*, FLR-15-4970-RPTT (N.Y.C. Dep't of Fin., Oct. 16, 2015). The same result was obtained regarding the sale of two Manhattan co-op apartment units that were not physically connected, but where the two units were occupied as a single residence for 44 years, and the purchaser of the two units intended to have them physically combined. *Finance Letter Ruling*, FLR-16-4977-RPTT (N.Y.C. Dep't of Fin., June 9, 2016). The Department has even sanctioned the lower RPTT rate for the sale of two condominium units to an individual purchaser where the two units were physically combined many years earlier, but where permits for the combination were never filed with the New York City Buildings Department. *Finance Letter Ruling*, FLR-15-4973/RPT (N.Y.C. Dep't of Fin., Sept. 24, 2015).

  - The Department held that the sale of a single-family house classified as a Class A-1 single family dwelling for real property tax purposes qualified for the lower RPTT rate on transfers of residential real property, even though the Certificate of Occupancy described the property as including a doctor's office. *Finance Letter Ruling*, FLR-14-4962/RPTT (N.Y.C. Dep't of Fin., May 19, 2015). In another ruling, the transfer of Manhattan property classified as Class 1 residential real property, 17% of which comprised commercial space on the ground floor, was also found to qualify for the lower RPTT rate because the property is a one-, two- or three-family house and categorized as a Class 1 property (the ruling referred to the property as both a "building" and a "one family home"). *Finance Letter Ruling*, FLR-15-4975 (N.Y.C. Dep't of Fin., May 13, 2016).

  - The sale of a residential condominium unit and the sale to the same purchaser of a noncontiguous "suite unit" in the condominium's tower—where suite usage was limited to, among other things, residential use only by domestic employees of the condo unit owner or by certain family members of the owner—qualifies for the lower RPTT rate on sales of individual condominium units. *Finance Letter Ruling*, FLR-14-4963-RPTT (N.Y.C. Dep't of Fin., June 15, 2015). The ruling cites to *Matter of Rosenblum*, TAT(E)01-31(RP) (N.Y.C. Tax App. Trib., Sept. 12, 2006), where the City Tribunal held that a similar arrangement regarding "suite units" was an integral part of the primary residential condominium unit. A similar ruling was issued regarding the sale of individual residential condominium units where the purchaser could also purchase a "studio unit" with restrictions similar to those discussed in the prior ruling. *Finance Letter Ruling*, FLR-14-4965-RPTT (N.Y.C. Dep't of Fin., June 15, 2015).

- **Effect of corporate reorganization on S corporation's general corporation tax filing obligation.** A letter ruling under the general corporation tax ("GCT") involved a federal S corporation that underwent a mid-year reorganization in 2014 in a transaction that qualified for exemption under IRC § 368(1)(a)(F).

continued on page 3

Under that reorganization, Old S Corp. (a GCT filer) converted to a single-member LLC ("NewCo LLC") owned by NewCo, a newly created federal S corporation. Thereafter, all of Old S Corp.'s assets were owned by NewCo LLC, a disregarded entity for income tax purposes. The question presented was whether NewCo (formed in mid-2014) should file a single GCT return for the entire 2014 year or whether short period GCT returns should be filed by Old S Corp. (for the period through the date of the reorganization) and by NewCo (for the period after the reorganization).

The Department ruled that NewCo should file a single GCT return for the entire 2014 year. It reasoned that since NewCo LLC (which, after the reorganization, owned the assets held by Old S Corp.) was a disregarded entity, NewCo is considered the owner of those assets for income tax purposes. Even though the GCT law does not recognize federal S corporation status, the Department concluded that the same tax year for federal purposes should apply for GCT purposes. Under IRC § 368(a)(1)(F), the two short years constituted a single taxable year of the acquiring entity, in this case NewCo. *Finance Letter Ruling*, FLR-15-4966-GCT (N.Y.C. Dep't of Fin., June 3, 2015).

Additional Insights

It appears that the Department is no longer posting its letter rulings on its website, thereby making it necessary for taxpayers to obtain them through the Freedom of Information Law, a cumbersome process. Even though letter rulings are only binding on the Department with respect to the named requester, they provide useful guidance about the Department's positions. Needless to say, the Department should post all letter rulings on its website in a timely fashion.

Tribunal Finds Adult Club Admission Charges Subject to Sales Tax

By Hollis L. Hyans

In the latest decision in a line of cases dealing with the same adult entertainment club, the New York State Tax Appeals Tribunal, reversing in part a decision of an Administrative Law Judge, has held that admission charges to an adult entertainment club are subject to sales tax, as are charges for admission to private rooms at the club. *Matter of 677 New Loudon d/b/a Nite Moves, et al.*, DTA Nos. 824333, 824334 & 824335 (N.Y.S. Tax App. Trib., Aug. 25, 2016).

Facts. 677 New Loudon Corporation operated an adult entertainment club (the "Club") in Latham, New York, which featured semi-nude and nude dancing by females, lap or table dances and private dances. It serves non-alcoholic beverages but no food or alcohol. It had one stage illuminated by spotlights in a large lounge area of about 28 feet by 34 feet; six rooms, each about 5 feet by 6 feet, designated for couch dances; a dressing room for employees; and lavatories. To enter the Club, customers paid an admission charge of $4 prior to 5:00 p.m. and $11 thereafter. The admission charge did not include drinks, which were usually priced at $3. Beverage sales accounted for about 16% of gross revenues. Charges for private dances varied depending on the duration chosen by the customer and whether the performer was topless or fully nude. Generally, the price of a dance lasting one song was $20 for topless or $30 for nude; for four songs, the topless charge was $55 and the nude charge $75. As stated in the Tribunal's findings of fact, the owner and one of the dancers both testified that the ultimate goal at the Club was to "entice customers to purchase private dances" because that generated the most revenue.

After an audit, the Department assessed sales tax on a variety of charges, with the largest disputed issues concerning the admission charges and the charges for private dances.

The Law. Sales tax applies to "[a]ny admission charge . . . in excess of ten cents to . . . any place of amusement in the state, except charges for admission to . . . dramatic or musical arts performances." Tax Law § 1105(f)(1). The exact term "dramatic or musical arts performances" is not defined in the statute, but a "dramatic or musical arts admission charge" is defined as "[a]ny admission charge paid for admission to a theatre, opera house, concert hall or other hall or place of assembly for a live dramatic, choreographic or musical performance." Tax Law § 1101(d)(5). Sales tax is also imposed on "[t]he amount

continued on page 4

paid as charges of a roof garden, cabaret or other similar place in the state." Tax Law § 1105(f)(3). A "roof garden, cabaret or other similar place" is defined as: "[a]ny roof garden, cabaret or other similar place which furnishes a public performance for profit, but not including a place where merely live dramatic or musical arts performances are offered in conjunction with the serving or selling of food, refreshment or merchandise, so long as such serving or selling of food, refreshment or merchandise is merely incidental to such performances." Tax Law § 1101(d)(12).

Arguments and Procedural Background. The Club argued that both the door admission charges and private dance charges were excluded from tax because the performances qualified as dramatic, choreographic or musical performances and, in particular, that the dances were choreographed. The Club presented the testimony of its owner and two dancers, who testified that they choreographed their routines for the main stage, lap dances and private dances. Testimony was also presented from four expert witnesses (a cultural anthropologist; a choreographer; a gymnast, coach, pole dancing teacher and personal trainer; and a choreographer, dance teacher and owner of a dance center) and an entertainment critic from the Albany *Times Union* newspaper. All four experts had viewed videos of performances on the main stage and in the private rooms. Their testimony generally established that the Club was a theater, and that the performances were detailed, pre-planned and choreographed. One expert also visited the Club and observed dances on the main stage and one private dance, and interviewed the dancer. She testified that the private dance was "kind of the same thing" as the stage dance but constrained by the small space. The entertainment critic observed the stage show and paid for a lap dance, and testified that the dancing was art and, while "'terrible art,'" that "'bad art is still art, . . . no matter how uncomfortable it makes us or how the majority views it.'"

Prior Proceedings. The Club had been the subject of a prior audit and challenged the results all the way up to the Court of Appeals, New York's highest court. The Court of Appeals, in a 4-3 decision, held that general admission charges and the private dance charges were subject to sales tax and not excluded as charges for musical arts performances or choreographed performances. It found that the Club had failed to carry its burden of proof to show the dances qualified as choreographed performances because its one expert who had testified had not actually observed any of the dances in question. *Matter of 677 New Loudon Corp. v. State of New York Tax App. Trib.*, 19 N.Y.3d 1058 (2012). Three judges dissented, including the chief judge, concluding 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.

The Tribunal . . . found that even though the dances were choreographed, the private dance rooms did not qualify as a theater, hall or other place of assembly . . . because they were "physically too small" for an audience and did not have a stage or theatrical lighting.

The ALJ Decision. The ALJ found that the door admission charges were not subject to sales tax, concluding that they were charges for admission to choreographed performances, which are excluded from tax under Tax Law § 1105(f)(1). Although the Department had argued that the case was controlled by the earlier decision of the Court of Appeals, the ALJ found that the Club's evidentiary presentations in the new case, including testimony by experts who this time had actually viewed videos or live presentations of the dances, overcame the failure of proof in the earlier case and established that the performances were choreographed. However, the ALJ found that the charges for the private dances were taxable because the Club failed to demonstrate that the private dances were choreographed, due to significant limitations in the space of the private rooms and differences between the stage performances and the private dances, and the fact that the expert witnesses had only viewed videos of private dances staged by the Club's employees, which conflicted with the description of the dances by both the supervising auditor and the Club's owner.

Tribunal Decision. While agreeing that the earlier decision against the Club was not binding and that, this time around, the Club had established that the dances on the main stage were indeed choreographed, the Tribunal nonetheless found the admission charges to be taxable on a theory that was not discussed in the ALJ decision. The Tribunal first found that even though the dances were choreographed, the private dance rooms did not qualify as a theater, hall or other place of assembly where such performances need to be held to be entitled to the "choreographic" exclusion set forth in Tax Law § 1101(d)(5) because they were "physically too small"

continued on page 5

for an audience and did not have a stage or theatrical lighting. Then, the Tribunal held, not only did this mean the charges for private dances were taxable, it also meant that the admission charges were taxable too, because the door admission charges "allowed customers the option of paying for the private performances," and there was no other means by which a customer could purchase a private dance without first paying the door admission charge. Because the door admission charges were for access to both the large stage area and then eventually the private rooms—although an additional charge was required for private rooms—the Tribunal concluded that the door admission charges were not excluded from tax as payments for choreographic performances. Finally, the Tribunal rejected all of the club's constitutional arguments, characterizing them not as challenging the statutes as unconstitutional on their face but as only arguing that the statutes were being applied unconstitutionally, and agreeing with the ALJ who had concluded that the Club had offered no evidence that it was treated any differently than other similarly situated taxpayers.

Additional Insights

The Tribunal appears to have applied a theory not raised on audit or addressed by the ALJ: whether the venue qualified as a theater, hall or other place of assembly. Therefore, it is not clear how well developed the facts and law were regarding whether or not the private rooms were halls or theaters within the meaning of the statute, since there is no discussion of legislative history, no discussion of evidence submitted on the issue, or any recitation of arguments made by either side on whether the statutory language did or did not cover this type of venue.

Also, the Tribunal noted in a footnote that it was "not unsympathetic" to the Club's request that it reconsider its previous holding in the earlier years' case regarding whether the language concerning choreographic dramatic or musical arts performances is an exclusion from tax or an exemption, noting that the earlier Tribunal decision dealt with the issue in a "cursory manner," indicating that it was not disputed. It does not appear from the earlier decisions that the issue was in fact considered or argued by the parties. However, it can be an important distinction, because if the provision is an exclusion, it is generally the Department's burden to prove that the tax applies, while a taxpayer generally bears the burden of establishing it is entitled to a statutory exemption. The Tribunal noted that this request would have to be addressed to the Court of Appeals, which had affirmed the earlier treatment of the statutory language as an exemption, although again without any explicit consideration of the issue.

ALJ Holds Elevator Purchases Are Subject to Sales and Use Tax

By Michael J. Hilkin

A New York State Administrative Law Judge has held that a limited liability company's purchases of elevators, along with service and maintenance sales related to the elevators, are subject to sales and use tax. *Matter of Titan Elevator & Lift LLC, et al.*, DTA Nos. 825845, 825858, & 825859 (N.Y.S. Div. of Tax App., Sept. 1, 2016). In reaching his conclusion, the ALJ rejected the company's contention that the purchases and sales qualified for a statutory exemption applicable to medical equipment.

Facts. Petitioner ("Titan") is a New York entity in the business of installing and servicing small elevators for use in homes and small business locations. Titan did not register as a sales tax vendor in New York. The Department audited Titan for the period December 1, 2003, through November 30, 2009, and initially requested books and records for the entire period. According to the Department, Titan's records were not adequate to conduct a detailed audit of the entire period, and it treated the year 2007 as a "test period" because it was the only year for which Titan had purchase and sales invoice records.

The Department examined Titan's 2007 retail sales to calculate sales tax due from the service and maintenance of elevators for the entire audit period. The Department examined Titan's 2007 expense purchases to calculate tax due on Titan's purchases of materials used in the installation of elevators. Titan did not pay sales tax on any of its purchases of such materials. The Department ultimately issued Titan a sales and use tax assessment, which included penalties, and also issued assessments to two married individuals as "responsible officers or responsible persons" of Titan.

During the audit, the Department rejected Titan's claims that its services sales, along with its purchases of materials for installing elevators, constituted sales related to medical equipment exempt from sales and use tax. The Department claimed that Titan did not adequately document that the elevators related to the materials purchased were for use by individuals with disabilities. Notably, while reviewing documents in the office of Titan's accountant, the Department found letters, purportedly from Titan's customers, stating that such customers purchased and had installed the elevators "for medical purposes in order to create accessibility in the home." The Department disregarded these letters as

continued on page 6

unreliable, however, because its investigator determined that in one instance a letter was changed after the individual had signed it, and in two other instances, the individuals whose names appeared on a letter said that they had never seen the letter.

Department regulations require that in order to qualify for the medical equipment exemption, the equipment in question "must be primarily and customarily used for medical purposes and not be generally useful in the absence of illness, injury or physical incapacity."

Tax Law. Sales of tangible personal property, and certain sales of tangible personal property installation and maintenance services, are generally subject to sales and use tax unless a statutory exemption applies. Tax Law §§ 1105(a) & (c)(3), 1110(a), 1115.

Titan apparently did not dispute that the material purchases and service sales at issue were subject to sales and use tax but instead argued that its purchases and sales were exempt from sales and use tax either as "medical equipment" and "supplies" used "to correct or alleviate physical capacity" or as "prosthetic aids." Tax Law §§ 1115(a)(3) & (4). Department regulations require that, in order to qualify for the medical equipment exemption, the equipment in question "must be primarily and customarily used for medical purposes and not be generally useful in the absence of illness, injury or physical incapacity." 20 NYCRR 528.4(e)(2).

The Decision. The ALJ concluded that the Department properly assessed sales and use tax on Titan's purchases of materials to install elevators and on its sales of installation and maintenance services related to such elevators. The ALJ explained that persons claiming an exemption from sales and use tax "have the burden of proving their entitlement to" such exemption, and Titan failed to meet its burden.

Titan attempted to satisfy its burden by presenting letters from the suppliers of the equipment that it installed. One supplier's letter stated that from 2003 to 2008, it only manufactured residential disabled accessible elevators for Titan, and another supplier's letter stated that all of the equipment that it supplied to Titan was for residential accessibility installations and that such equipment met the requirements of the American Society of Mechanical Engineers' Code for disabled accessible elevators. The ALJ, however, concluded that "Titan did not have any documentation, such as contracts or memorandums to show that the cost of the materials used to install the elevators were sales not subject to tax."

Separately, the ALJ upheld the penalties imposed on Titan, reasoning that penalties were appropriate because Titan failed to maintain and provide proper records and indeed did underreport its sales and use tax liability. Finally, the ALJ rejected the request that "innocent spouse treatment" be applied to one of the individuals who was issued an assessment as a responsible person because the sales and use tax statutes do not contain any innocent spouse relief provision and, even if they did, no evidence was offered to support innocent spouse relief.

Additional Insights

This case highlights the difficulties that businesses may encounter in claiming a sales and use tax exemption without maintaining detailed documentation contemporaneous with any applicable purchases and sales. Among other things, the ALJ cited sales and use tax statutes explaining that the records a company is required to maintain must "include a true copy of each sales slip, invoice, receipt, statement or memorandum." Tax Law § 1135(a)(1).

Separately, this case is unusual in that an individual who was assessed for a business's sales and use tax liability as a "responsible person" attempted to obtain innocent spouse relief from such assessment. Innocent spouse relief is provided for by the personal income tax statutes, and may be available when, taking all facts and circumstances into account, it would be "inequitable" to hold a spouse liable for a joint return's understatement. Tax Law § 654; IRC § 6015(b). As innocent spouse relief is not provided by any sales and use tax statute, the ALJ concluded that he lacked the power in general equity to consider applying innocent spouse relief in the case.

INSIGHTS IN BRIEF

CPR and First Aid Services Are Not Subject to Sales Tax, but Training Manuals May Be Taxable

A sole proprietorship that will provide in-person CPR and first aid instruction to the general public is not required to obtain a Certificate of Authority to collect sales and use tax, even if the taxpayer provides training manuals at no extra charge to those attending the training, because those services are not subject to sales tax. The training manuals would be considered an integral component of the broader services and would not be considered a taxable sale of tangible personal

continued on page 7

property on which sales tax must be collected. *Advisory Opinion*, TSB-A-16(23)S (N.Y.S. Dep't of Taxation & Fin., July 8, 2016) (released Aug. 17, 2016). However, if the taxpayer charges separately for the training manuals, or sells them to customers who did not attend the in-person training, the taxpayer would be selling tangible personal property subject to sales tax and must apply for a Certificate of Authority at least 20 days prior to commencing business in the State.

ALJ Upholds Denial of Deductions for Business Expenses Due to Lack of Substantiation

In *Matter of John and Jill Miskanic*, DTA No. 826550 (N.Y.S. Div. of Tax App., Sept. 15, 2016), a New York State Administrative Law Judge upheld the Department's denial of deductions claimed for business expenses under the personal income tax. Although the Miskanics claimed deductions for expenses arising from the operation of a business named "Jack in the Box Entertainment, Inc.," which they said was engaged in entertainment management, the ALJ found that they had failed to submit sufficient records demonstrating that the claimed expenses were in fact business related rather than personal. The ALJ determined that the only records offered were bank records showing withdrawals from a personal bank account, which failed to demonstrate even how the funds were actually used, much less that they were incurred for properly deductible business expenses.