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Judge Dismisses $2.4 Billion False Claims Act Suit Brought Against Citigroup

By Matthew F. Cammarata

A New York State Supreme Court Judge has dismissed a *qui tam* False Claims Act ("FCA") suit brought by Eric Rasmusen, an economics professor at Indiana University (the "Relator"), against Citigroup Inc. ("Citigroup"). *State of New York ex rel Eric Rasmusen v. Citigroup Inc.*, No.100175/2013 (Sup. Ct. N.Y. Cnty., May 17, 2017). The suit alleged that Citigroup intentionally failed to pay approximately $800 million in New York State taxes as a result of what the Relator characterized as the improper use of net operating loss ("NOL") deductions. New York State Supreme Court Judge Charles E. Ramos granted Citigroup's motion to dismiss the case in a ruling from the bench.

Facts. During the 2008 financial crisis, Congress established the Troubled Asset Relief Program ("TARP"), authorizing the Department of the Treasury ("Treasury") to purchase equity interests in publicly traded companies in order to stabilize the troubled banking and financial industry. Pursuant to its authority under TARP, the Treasury purchased approximately $45 billion of stock in Citigroup. The Relator claimed that the purchase of Citigroup's stock constituted an "ownership change" within the meaning of Internal Revenue Code ("IRC") § 382. If a corporation experiences an "ownership change" under IRC § 382, the corporation's ability to carry forward NOLs is restricted if the ownership change occurs between the time the company's NOLs arise and the time that it uses the NOLs to reduce its tax liability.

In a series of notices, the Internal Revenue Service ("IRS") explicitly ruled that purchases of public stock by the Treasury under TARP would not constitute an "ownership change" under IRC § 382, effectively removing the limitation on the use of NOLs imposed by § 382 for banks and financial institutions included in the TARP program. *See* IRS Notice 2008-100; IRS Notice 2009-14; IRS Notice 2009-38; IRS Notice 2010-2.

Relying on this explicit IRS authority, Citigroup claimed NOLs on its federal tax returns despite the Treasury's purchase of Citigroup stock and without any limitations imposed by IRC § 382. Under the former bank franchise tax, the Tax Law allowed NOL deductions, which were "presumably the same as the net operating loss deduction allowed under section one hundred seventy-two of the internal revenue code." *See* Former Tax Law § 1453(k-1).

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Although the Relator acknowledged this explicit guidance from the Treasury in his complaint, he nonetheless claimed that the American Recovery and Reinvestment Act of 2009 ("ARRA") "prospectively repealed" the notices issued by the IRS because Congress expressly stated in the ARRA "that the IRS was not authorized to provide exemptions or special rules that are restricted to particular industries or classes of taxpayers." The Relator therefore alleged that the IRS Notices were improperly issued by the IRS, were not valid under federal law, and that Citigroup erroneously relied on the IRS Notices in its tax reporting. Moreover, even if the IRS Notices were valid under federal law, the Relator claimed that they were not incorporated into the New York State Tax Law. Because Citigroup claimed the NOL deductions on its federal income tax returns, and because the Tax Law incorporates the federal NOL deduction, the Relator claimed that Citigroup improperly and intentionally reduced its New York State tax liability.

[T]he dismissal of the case before any discovery represents a significant taxpayer victory, and an eventual written decision on the motion could provide valuable guidance for taxpayers defending against *qui tam* FCA actions.

The *qui tam* complaint was filed in 2013 but was not unsealed until September 2015, when New York Attorney General Eric Schneiderman declined to intervene and pursue the case on behalf of the State. Citigroup removed the case to federal court, but the Federal District Court remanded the case back to state court, holding that it lacked subject matter jurisdiction over the case, finding that it failed to raise a federal issue. *State of New York ex rel. Eric Rasmusen v. Citigroup*, No. 1:15-cv-7826 (LAK) (S.D.N.Y. Dec. 2, 2016). On January 26, 2017, Citigroup sought dismissal of the Relator's complaint pursuant to CPLR § 3211(a)(1), (3), and (7).

The Motion to Dismiss. Citigroup moved to dismiss the *qui tam* complaint, characterizing the Relator's allegations as "his personal opinion" that Citigroup engaged in fraud "by taking tax deductions that were expressly permitted by authoritative guidance promulgated by" the Treasury. Citigroup sought dismissal for three principal reasons. First, the Relator alleged no "nonpublic facts" to support his allegations. The FCA expressly requires dismissal of any actions based on facts that were publicly disclosed prior to the suit's filing. N.Y. State Fin. Law § 190(9)(b). According to Citigroup, the facts underlying the Relator's suit were widely and publicly disclosed in various forms from scholarly articles to the media. Citigroup even pointed to a blog post written by the Relator, in which he allegedly admits that the complaint was based not on any nonpublic facts but rather on his "specialized legal analysis."

Second, Citigroup claimed that the complaint failed to plead that it submitted a false record or statement in connection with its New York tax returns as required by the FCA. Instead, Citigroup noted that it relied on explicit federal authority in claiming its NOL deductions and that the Tax Law expressly refers to and incorporates federal law concerning NOL deductions. Citigroup's NOL deductions were therefore claimed in full compliance with federal and New York law.

Finally, Citigroup claimed that even if the Relator had properly pleaded that Citigroup made claims that were "false" under the FCA, the complaint nonetheless failed to plead that Citigroup *knew* that the allegations were false. FCA liability only attaches to statements and claims that are "knowingly" false. N.Y. State Fin. Law § 189. Citigroup argued that the complaint should be dismissed because the Relator did not even allege that Citigroup "did not honestly believe that its deductions were proper." Instead, the complaint actually acknowledged that Citigroup relied on explicit federal authority in claiming its NOL deductions.

On May 17, 2017, Justice Ramos granted Citigroup's motion to dismiss in a ruling from the bench. There is no written opinion explaining the Judge's ruling. The Court's questions during the hearing, however, indicate a strong skepticism of the Relator's legal theory, including a question asking why the returns filed by Citicorp constitute a false statement, since "[t]hey're not misrepresenting anything, they're just saying this is the net operating loss which we have taken under the federal statute . . ." Oral Argument Transcript, p. 20.

Additional Insights

In the absence of a written opinion, the basis for the judge's dismissal is unclear. However, the dismissal of the case before any discovery represents a significant taxpayer victory, and an eventual written decision on the motion could provide valuable guidance for taxpayers defending against *qui tam* FCA actions. The FCA is still a relatively new statute in New York, and was not made applicable to tax claims until August 2010. To date there has been no in-depth judicial

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scrutiny in the tax context of what constitutes either a "false" claim or a "knowingly" false claim. Citigroup's victory in this case indicates that taxpayers may have greater success in defending against *qui tam* actions brought by relators who are otherwise disconnected from the operation of the taxpayer's business and who seek recovery of significant damages using the FCA based upon generalized claims and publicly available information. As Citigroup argued in its motion to dismiss, the FCA "does not permit *qui tam* actions by 'parasitic . . . opportunists who attempt to capitalize on public information without seriously contributing to the disclosure' of any fraud" (quoting *United States ex rel. Doe v. John Doe Corp.*, 960 F.2d 318, 321 (2d Cir. 1992)).

Once the trial court's decision is final, it may be appealed to the Appellate Division, First Department.

Tribunal Finds Adult Club Scrip Charges Subject to Sales Tax

By Hollis L. Hyans

In another decision dealing with the issue of the applicability of sales tax to adult club charges, the New York State Tax Appeals Tribunal has upheld the determination of an Administrative Law Judge and found that charges for scrip used for table dances and tipping dancers at an adult entertainment club are subject to sales tax. *Matter of The Executive Club LLC*, DTA No. 825850 (N.Y.S. Tax App. Trib., Apr. 19, 2017).

Facts. The Executive Club LLC operated the Penthouse Executive Club (the "Club"), an adult entertainment club in New York City. The Club generated revenue from admissions, bar sales, food sales, and performances of the entertainers. It collected and remitted sales tax on its admission charges, which varied depending on the day of the week and were paid with cash or credit card only.

The Club also sold scrip, called "executive dollars," which could be purchased with credit cards and which explicitly stated that it could be used only for table dances and tipping. The Club added a 20% surcharge when executive dollars were purchased. Entertainers earned their income from customers and were paid by the customers in cash or scrip. Minimum fees paid to entertainers for personal dances were established by the Club based upon industry custom. Entertainers paid the Club a house fee to perform at the Club's facilities and, after payment of that fee, redeemed executive dollars from the Club, for which the Club charged a 13% fee. Private rooms at the Club could be rented by customers from a separate entity, Rooms With a View, LLC, and had to be paid for with cash or a credit card; executive dollars were not accepted.

After an audit, the Department of Taxation and Finance determined that the sales of executive dollars were taxable as admission charges to a place of amusement under Tax Law § 1105(f)(1), and issued notices of determination seeking additional tax of over $2.4 million, plus interest. No penalties appear to have been asserted.

ALJ Decision. At the hearing, a question of fact arose as to whether executive dollars could be used for any purpose within the Club, as the auditor contended, or if they could be used only for tipping and paying entertainers. The ALJ found that the executive dollars could not be used for admission to private rooms or for any purpose other than tipping and paying entertainers. However, the ALJ determined that the decision in *Matter of Marchello*, DTA No.821443 (N.Y.S. Tax App. Trib., Apr. 14, 2011), was controlling, and that, since the Tribunal in *Marchello* had held that receipts from the sale of scrip were taxable as amusement charges, the Club's executive dollars were similarly taxable, despite acknowledging that in *Marchello* the scrip could be used for admission to private rooms, which was not the case at the Club.

Although the . . . ALJ had . . . found that the executive dollars could not be used for admission, . . . the Tribunal concluded that the ALJ was using only the "common understanding" of the word "admission" "as opposed to the statutory term 'admission charges' . . . which is inclusive of charges for 'entertainment or amusement.'"

On exception, the Club argued that receipts from the sale of executive dollars cannot be taxed as admission charges, because the executive dollars do not grant admission to anything, and raised a new legal argument that personal dances are not entertainment or amusement but instead constitute an "intimate personal service." It also contended that the ALJ had failed to address its primary argument that executive dollars are intangible property, similar to gift cards, and are not subject to tax at the time purchased.

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Tribunal Decision. The Tribunal upheld the decision of the ALJ, although not in reliance on *Marchello*, which it never mentions other than to note the ALJ's reliance. Instead, the Tribunal relied almost entirely on its more recent decision in *Matter of HDV Manhattan, LLC*, DTA Nos. 824229 & 824231-824234 (N.Y.S. Tax App. Trib., Feb.12, 2016), which it found controlling due to what it determined were closely similar facts. Although the Club argued that the ALJ had specifically found that the executive dollars could not be used for admission to the Club or to the private rooms, the Tribunal concluded that the ALJ was using only the "common understanding" of the word "admission" "as opposed to the statutory term 'admission charges' set forth in Tax Law § 1101(d)(2), which is inclusive of charges for 'entertainment or amusement.'" Since the Tribunal determined that personal dances constitute "entertainment," it found that receipts from sales of executive dollars were taxable to the extent the dollars were used for personal dances. While acknowledging that executive dollars were also used for tips to entertainers and other Club employees, and that such receipts "may not be subject to tax," the Tribunal found that the Club did not raise that claim or present evidence on that issue.

The Tribunal also rejected the argument that the sale of executive dollars is not a taxable event, in the same manner that the sale of a gift card is not a taxable event, finding that a similar argument had been rejected in *HDV Manhattan* because "implicit in this assertion" is the argument that the entertainers were responsible for collecting tax and that even though the Club in the present case did not receive the charges for the private room, which instead were paid to a separate corporation, there were "more than enough similarities to [*HDV Manhattan*] to find that the Club is indeed responsible for the collection of the sales taxes on the receipts from the admission charges for the personal dances."

Finally, the Tribunal rejected the arguments that the Club provides not entertainment but a nontaxable "intimate personal service" "similar to a therapeutic massage conducted in a sensual manner or personal services provided by a sex therapist" or that its operations are similar to those of a flea market that issues scrip for the convenience of its concessionaires since the Club presented no evidence in support of these arguments.

Additional Insights

The Tribunal's decision, which acknowledges that the executive dollars cannot be used for admission charges but relies on an argument that they can nonetheless be taxable as admission charges because they are charges for the "entertainment" of dances, is arguably inconsistent with a Court of Appeals decision and with the Department's own regulations and guidance regarding amusement parks. In *Fairland Amusements, Inc. v. State Tax Commission*, 66 N.Y.2d 932 (1985), the Court of Appeals expressly found that the tax on admission charges is imposed only on a charge, if any, to *enter* a place of amusement and is *not* imposed on all charges incurred once inside the place of amusement. This concept has been incorporated by the Department into its regulations and in guidance issued to taxpayers. *See* 20 NYCRR § 527.10(b)(1)(ii), (Examples 3 & 4); N.Y. Technical Service Bureau Memorandum, TSB-M-87(15)S, "Taxable Status of Amusement Rides and Admission Charges" (N.Y.S. Dep't of Taxation & Fin., Nov. 13, 1987) (sales of tickets or tokens solely for the use of amusement rides are not subject to tax); Tax Bulletin, TB-ST-30 (N.Y.S. Dep't of Taxation & Fin., July 28, 2010) ("[a] separate charge to play a game at an amusement park is not subject to sales tax").

Since the Court of Appeals and the Department itself have found that charges for entertainment other than admission charges are not separately taxable, the Tribunal seems to be moving in a different direction when considering the charges incurred not for admission to adult clubs but for other services available within adult entertainment clubs.

Note: Morrison & Foerster LLP represents the taxpayers in *HDV Manhattan*, which is pending on appeal before the Appellate Division, Third Department.

Tribunal Rules That S Corporation's Activities Were Engaged in for Profit, Affirming That Losses Were Deductible by Shareholders

By Michael J. Hilkin

Upholding an Administrative Law Judge decision, the New York State Tax Appeals Tribunal rejected the State Tax Department's claim that an S corporation's activities were not engaged in for profit and therefore found that its individual owners could deduct losses from the S corporation on their State resident income tax returns. *Matter of Steve and Linda Horn*, DTA No. 825333 (N.Y.S. Tax App. Trib., Apr. 20, 2017).

Facts. Petitioners Steve and Linda Horn are a married couple residing in New York. In the 1970s, they started an S corporation (the "Company"), which eventually conducted three different businesses: the television commercial production business, the real estate business,

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and the antiques business. The case at hand focuses on the years 2004 through 2009 (the "Audit Period").

<u>Television commercial production business.</u> The Company initially engaged in a television commercial production business carried out by Mr. and Mrs. Horn, along with a cadre of full-time employees and freelancers, some of whom were family members. At the time the business began, Mr. Horn was experiencing financial difficulties and had significant debt arising from a former business. The Company thus was financed by Mrs. Horn and initially operated out of the Horns' apartment.

Over the decades, the commercial production business became both profitable and professionally recognized, producing commercials for large companies including AT&T, McDonalds, Coke, and Pepsi, along with the iconic "I Love New York" commercials. Mr. Horn, who directed the commercials, earned numerous accolades, and a reel of the business' commercials has been inducted into the collections of the Museum of Modern Art. However, by 2004 to 2005, market forces, such as the shift from film to digital production, led the Company to begin the process of winding down its commercial production business.

<u>Real estate investment business.</u> In the early 1980s, the Company began engaging in a real estate investment business, focusing on New York City and the surrounding area. The New York area properties sold by the Company were consistently sold at a profit.

In 2004, the Company expanded to the Palm Beach, Florida market, purchasing three properties that required renovations. Many of the needed renovations were delayed by two successive hurricanes that struck the Palm Beach area, and one of the properties was subsequently transferred to a related entity in satisfaction of a loan to the Company by the Horns to purchase the property. Subsequent to the Audit Period, the Company sold one of the properties at a profit.

<u>Antiques business.</u> The antiques business was the brainchild of Mrs. Horn, who admittedly enjoyed the business and found it "fascinating." In carrying out the antiques business, the Company sought to establish a brand under Mrs. Horn's name. Numerous employees, including some family members, helped the Company conduct its antiques business, but Mrs. Horn made all inventory purchase decisions. While Mrs. Horn always expected the inventory items to appreciate in value, the initial concept of the business was that it would not be particularly profitable and would be secondary to the commercial production and real estate businesses.

However, once the Company's commercial production business began the wind-down process in 2004 and 2005, the Company decided to attempt to grow its antique business into a mass market business. As part of the scaling up process, the Company started selling re-creations or reproductions of antiques so that it could offer products at more affordable prices. Additionally, it leased and renovated a new storefront for the antiques business and also renovated properties owned by another related entity leased to the Company and used by it to receive and store inventory.

The Tribunal upheld the ALJ decision and allowed the Horns to deduct all of the losses incurred by the Company during the Audit Period.

In carrying out the antiques business, the Company pioneered a number of practices, including tracking the contact information and sales history of every customer who came into the Company's antiques store, as well as maintaining an information database to store information about the inventory. Certain competitors of the antiques business copied some of these practices.

Audit. During the Audit Period, the Company incurred losses, which for income tax purposes flowed through the S Corporation to the Horns. Some of these losses were claimed on the Horns' New York State personal income tax returns corresponding to the years in which the losses were incurred, while other losses were claimed as net operating loss carryforwards. On audit, the Department disallowed the losses claimed by the Horns in relation to the Company, concluding that the losses were disallowed for both federal and State purposes under Internal Revenue Code § 183 (commonly referred to as the "hobby loss rule"), which disallows deductions arising from losses related to activities "not engaged in for profit."

ALJ Decision. After a hearing, the Administrative Law Judge concluded that, for purposes of applying the hobby loss rule, the commercial production, real estate, and antiques businesses should be treated as separate endeavors, that all were engaged in for profit, and thus all of the losses incurred by the Company were deductible by the Horns as shareholders of the S corporation.

Tribunal Decision. The Tribunal upheld the ALJ decision and allowed the Horns to deduct all of the losses incurred by the Company during the Audit Period. In reaching its decision, the Tribunal first agreed with the ALJ that the Company's three businesses must each be examined independently for

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purposes of applying the hobby loss rule, stressing that there was no evidence that the businesses engaged in cross-advertising or other activities that synergistically generated leads or sales for the other or that the companies shared any client base.

Next, the Tribunal examined the activities of the commercial production business and determined that, although the business was winding down during the Audit Period, it was nonetheless carried out for purposes of making a profit. The Tribunal noted that it was undisputed that the commercial production business was historically carried out for a profit and relied on federal case law concluding that a business is allowed a "reasonable time to unwind" without being subject to the disallowance of losses under the hobby loss rule.

[T]he Tribunal found that Mrs. Horn's admission that she enjoyed the antiques business and found it "fascinating" was not determinative, citing federal case law stating that "suffering has never been made a prerequisite to deductibility."

Finally, the Tribunal concluded that the antiques and real estate businesses also were not subject to the hobby loss rule's prohibition on deductions. The Tribunal partially relied on a nine-factor analysis in a federal regulation (Treas. Reg. § 1.183-2(b)), which includes factors such as (a) the manner in which the taxpayer carries on the activity; (b) the expertise of the taxpayer or its advisors in carrying out a business; and (c) the time and effort expended in carrying out a business. The Tribunal added that while such factors may be "useful" in analyzing whether the hobby loss rule is applicable, ultimately "[i]t is the taxpayer's actual and honest intent to make a profit that renders the activity as having a profit motivation."

In concluding that the hobby loss rule did not apply to the antiques and real estate businesses, the Tribunal found, among other things, that both businesses were carried out in a "businesslike manner," and the price for which antiques and real estate properties were sold was significantly greater than the Company's purchase price for the items and properties. While acknowledging that one of the factors to be considered is the "elements of personal pleasure or recreation," the Tribunal found that Mrs. Horn's admission that she enjoyed the antiques business and found it "fascinating" was not determinative, citing federal case law stating that "suffering has never been made a prerequisite to deductibility."

Additional Insights

It does not appear that the IRS ever disallowed deductions claimed by the Horns on the issue of whether the Company's losses under the hobby loss rule. While the Tribunal rejected the Department's legal conclusions supporting the assessment of the Horns, this case serves as a reminder that, even if the IRS raises no challenges, the Department can raise issues that arise under federal income tax law principles.

Separately, it is noteworthy that the Department challenged the profit motive for the antiques business led by Mrs. Horn based in part on facts and circumstances that were also historically present in the commercial production business led by Mr. Horn (which, prior to being wound down, was unquestionably engaged in for a profit). For example, the Department argued that the Company's employment of family members dictated against treating the antiques business as a business engaged in for a profit, even though the Horns also employed family members in its commercial production business. The Tribunal did not find such facts determinative.

NYC Issues UBT Statement of Audit Procedure on Basis Adjustments Under IRC Sections 734 and 743

By Kara M. Kraman

The New York City Department of Finance has issued a Statement of Audit Procedure ("SAP") addressing how adjustments made to the basis of partnership assets pursuant to IRC §§ 734 and 743 impact the calculation of unincorporated business taxable income under the unincorporated business tax ("UBT"). *Statement of Audit Procedure*, UBT-2017-1, (N.Y.C. Dep't of Fin., May 5, 2017). The SAP explains that basis adjustments to partnership assets made pursuant to IRC § 734 following a distribution of property will result in corresponding basis adjustments to partnership assets for UBT purposes, while basis adjustments to partnership assets made pursuant to IRC § 743 following a transfer of a partnership interest will not result in corresponding basis adjustments for UBT purposes.

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Calculation of UBT Taxable Income. Under the UBT, the taxable income of an unincorporated business is the excess of its "unincorporated business gross income" over its "unincorporated business deductions." Admin. Code. § 11-505. Federal gross income and federal deductions are the starting points for unincorporated business gross income and unincorporated business deductions. Gains, which are included in federal gross income, are defined as "the excess of the amount realized over the . . . basis for the property sold or exchanged." Treas. Reg. § 1.61-6(a).

The SAP confirms that a partnership's § 734 basis adjustments, which affect the partnership's subsequent calculations of federal income, gain, loss, and deduction, will be incorporated into the computation of the partnership's UBT taxable income.

The UBT does not contain any specific statutory modification to the federal calculation of basis, which is generally the cost of acquiring the property, subject to adjustment for depreciation and amortization. Since depreciation and amortization deductions are derived from, and reflected in, the basis of partnership assets, adjustments to the basis of a partnership's assets affect the size of the corresponding amortization and depreciation deductions for both federal and UBT purposes.

IRC Section 734. IRC § 734 provides the conditions for an adjustment to the basis of undistributed partnership property after a partnership distributes property to a partner. While generally a partnership may not adjust the basis of its assets following a distribution of property to a partner, where the partnership makes an election under IRC § 754, the partnership adjusts its basis in its undistributed property and does not make adjustments that apply separately to any particular partner. Treas. Reg. § 1.734-1.

For example, where a partner recognizes a gain on a liquidating distribution of her partnership interest, the partnership increases its basis in partnership property by the same amount. IRC § 734(b)(1)(A). The SAP confirms that a partnership's § 734 basis adjustments, which affect the partnership's subsequent calculations of federal income, gain, loss, and deduction, will be incorporated into the computation of the partnership's UBT taxable income. The SAP also provides an example of how § 734 affects UBT taxable income where there is a liquidating distribution of a partnership interest.

IRC Section 743. IRC § 743 provides conditions for an adjustment to the basis of partnership property following the transfer of an interest in a partnership. Under § 743, when a partner transfers its interest in the partnership, if the partnership makes an election under § 754, the partnership is permitted to adjust its basis in partnership property, but only with respect to the transferee partner.

For example, where a partnership interest is sold for an amount that is greater than the selling partner's basis in the partnership property, the partnership is permitted to increase its basis in the partnership property by the excess of the purchasing partner's basis in his newly acquired partnership interest (generally the purchase price) over the purchasing partner's proportionate share of the adjusted basis in the partnership's assets. IRC § 743(b)(1). However, this basis adjustment is made with respect to the transferee partner—the partnership may not adjust the common basis of the partnership assets. The SAP explains that in such a case, the partnership's UBT taxable income will not be affected because the basis adjustment made pursuant to § 743 affects only the *transferee's* income, gain, loss, and deduction. The SAP also provides an example where a sale of a partnership interest and the corresponding adjustment made pursuant to § 743(b) does not affect UBT taxable income.

Other Issues. The SAP also clarifies that in analyzing transfers of partnership interests and assets, the Department will follow (i) IRC § 707(a)(2)(B) (transactions between partner and partnership); (ii) IRC § 755 (rules for allocation of basis); (iii) Revenue Ruling 99-5 (1999-1 C.B. 434) (sale or contribution resulting in a disregarded entity becoming a partnership); and (iv) Revenue Ruling 99-6 (1999-1 C.B. 432) (sale resulting in a partnership becoming a disregarded entity).

Additional Insights

SAPs are issued by the Department of Finance primarily for use by audit staff and, while they do not have legal force or effect, they can be a useful source of guidance for understanding the audit process and the Department's policies. This SAP in particular provides welcome guidance in an area where there is almost none. With the exception of *Matter of Dolly Co. v. Tully*, 65 A.D.2d 99 (3d Dep't 1978), *appeal denied*, 46 N.Y.2d 710 (1979), which held that a partnership was not permitted to use § 743(b) to adjust the basis of partnership assets upward to take amortization deductions because

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§ 743(b) adjustments affect the transferee partner only under the long-repealed New York State UBT, there do not appear to be any other cases or pronouncements addressing UBT basis adjustments resulting from an IRC § 754 election.

Prior Net Operating Loss Conversion Subtraction Draft Regulations Released

By Irwin M. Slomka

The New York State Department of Taxation and Finance has released another set of draft Article 9-A regulation amendments under New York State corporate tax reform, this time relating to the Prior Net Operating Loss Conversion ("PNOLC") subtraction. *Computation of the Prior Net Operating Loss Conversion (PNOLC) Subtraction (N.Y.S. Dep't of Taxation & Fin., May 5, 2017).* The PNOLC subtraction is an important aspect of corporate tax reform, since it is the only device by which a corporation may utilize its unabsorbed net operating losses ("NOLs") incurred before the 2015 tax year (when corporate tax reform went into effect) as a deduction against its apportioned business income.

Basics of the PNOLC. The Tax Law provides considerable detail regarding the PNOLC calculation. A corporate taxpayer must first compute its PNOLC "subtraction pool," which involves several steps but in essence is based on the tax value of its unabsorbed NOLs at the end of its "base year"—the taxpayer's last taxable year beginning prior to 2015—multiplied by the taxpayer's apportionment factor in that base year. The taxpayer then has the option of deducting 1/10 of the PNOLC subtraction pool annually (but not over more than 20 years) until fully utilized or else it can make a revocable election to deduct 1/2 of the subtraction pool in each of the years 2015 and 2016, respectively. The PNOLC subtraction is applied before claiming the regular NOL deduction for the tax year.

Among the issues covered by the draft regulations:

- *Computation of the unabsorbed NOL.* The draft regulations generally apply pre-2015 New York State NOL limitations in computing the amount of unabsorbed net operating losses available for the PNOLC subtraction pool. For example, the draft provides that New York State NOLs must be applied to reduce the taxpayer's entire net income, even if the tax was paid on an alternative tax base in a given year. In addition, the draft applies both the pre-2015 "same source year" limitation and the limitation based on the amount deducted for federal purposes, two problematic limitations under the pre-2015 tax.
- *Changes to a corporation's unabsorbed NOL.* In a key interpretation that would provide some finality to the PNOLC subtraction pool computation, the draft regulations provide that unabsorbed NOLs from pre-2015 years can only be changed within the normal three-year statute of limitations for the Article 9-A return on which a PNOLC subtraction is first claimed. After the expiration of that statute of limitations, any federal RARs—whether they increase or decrease federal taxable income—would have no effect on the subtraction pool calculation.
- *Base year changes.* Similarly, changes to the taxpayer's base year apportionment factor—which is used to calculate its PNOLC subtraction pool available for carryforward—can only be made within the three-year statute of limitations for the base year.
- *Changes in the NYS combined group.* The draft regulations also provide detailed rules for computing the PNOLC subtraction where there are changes to the Article 9-A combined group, including when a member leaves the group. For instance, a departing member in a post-2014 tax year would be required to take its own PNOLC subtraction allotment (based on a percentage of the member's subtraction pool), as well as its share of the combined group's unused PNOLC carryforward, from the last year that it was part of the combined group.
- *IRC § 381 limitations.* In the case of a corporate acquisition, the acquiring corporation would be subject to the limitations under IRC § 381 regarding the unused PNOLC subtraction carryforward that the distributing or transferring corporation was subject to.

The draft PNOLC regulations provide much-needed clarity, including detailed examples, to this important part of corporate tax reform. Like the other tax reform regulations released by the Department since 2015, it is still in draft form and has not yet been formally proposed under the State Administrative Procedure Act. The Department is inviting comments by August 3, 2017.

INSIGHTS IN BRIEF

Tribunal Holds That Tax Department Did Not Meet Burden to Establish Fraud Penalties and That Taxpayer Is Entitled to Refund

The New York State Tax Appeals Tribunal found that an individual's guilty plea to "disorderly conduct" after being criminally charged for the repeated failure to file New York State personal income tax returns did not alone support a finding of civil tax fraud. *Matter of Darleen March*, DTA No. 826057 (N.Y.S. Tax App. Trib., May 10, 2017). Therefore, the Tribunal reversed an ALJ determination and held that the Department did not meet its burden of proof regarding the imposition of civil fraud penalties. However, regarding late filing and late payment penalties in other years, the Tribunal agreed with the ALJ in rejecting the taxpayer's claim that her deceased husband's alcoholism constituted reasonable cause for her failure to file and pay the tax and upheld those penalties.

Charges for Video Generating Services Ruled Taxable Charges for Pre-Written Software

The New York State Tax Department has ruled that an online product that enables customers to convert their photos and video clips into professional videos constitutes the provision of pre-written computer software subject to New York sales tax. *Advisory Opinion*, TSB-A-17(4)S (N.Y.S. Dep't of Taxation & Fin., Mar. 1, 2017) (released May 15, 2017). Customers upload photos and videos to the company's server and are given various customization options, after which the company's software is used to create a video. Although customers do not directly interact with the company's software, they have access to it through an online interface from which they create the videos. The Department concluded that this gave customers "constructive possession" over the software, and therefore the charges for the video service were subject to sales tax to the extent it was used by customers in New York State.

Tribunal Generally Upholds Sales Tax Audit Based on Estimation

The New York State Tax Appeals Tribunal has generally upheld the decision of an Administrative Law Judge sustaining the Department of Taxation and Revenue's imposition of additional sales tax on sales by a deli and grocery store of taxable products such as prepared foods, soda and beer, and cigarettes. *Matters of Majestic Deli Grocery, Inc. & Ahmed Alamrani*, DTA No. 825624 & 825625 (N.Y.S. Tax App. Trib. Apr. 14, 2017). The Tribunal found that, since the records kept by the corporation and produced on audit were incomplete and inadequate, the auditor was justified in relying on purchase information, projections made from what few records were available, and, with regard to cigarettes, markup percentages based on the Department's Publication 509, *Minimum Wholesale and Retail Cigarette Prices*, (N.Y.S. Dep't of Taxation & Fin., Mar. 2017). However, with regard to the Department's estimate of prepared food sales, the Tribunal rejected an extrapolation based on a 15-minute survey, finding that the short duration was only a "small fraction of the duration of any observation test sustained by this Tribunal or the courts" and that it was unreasonable to rely on such a "fleeting glimpse" of business activity, and cancelled the part of the assessment relying on that extrapolation.

Tribunal Sustains Use Tax on Materials Purchased by Contractor and Used in Capital Improvements

In *Matters of Andrew Costabile, Ralph Costabile & Michael Delponte*, DTA Nos. 826105-827107 (N.Y.S. Tax App. Trib. Apr. 14, 2017), the New York State Tax Appeals Tribunal sustained the Department's imposition of use tax on materials purchased by a business that acted both as a retailer of building products used in kitchens and baths and as a contractor performing installations of its products for some customers. While the business was accustomed to purchasing materials for resale, which would be subject to exclusion from the definition of retail sales, Tax Law § 1105(c)(5) provides that sale of tangible personal property to a contractor is a retail sale subject to tax, and the Tribunal rejected the arguments that the business should not be liable for the tax because the business owners self-identified as retailers and did not know at the time of purchase whether the materials would be resold as merchandise or used by the business acting as a contractor. The Tribunal found that the "clear language of the law and regulations" required that, where materials are used in the performance of capital improvements, the purchase of the materials is subject to tax and that the business could have accounted for the tax expense when providing estimates for its capital improvement projects.

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