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NEW YORK TAX INSIGHTS

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APPELLATE COURT REVERSES TRIBUNAL AND GRANTS QEZE PROPERTY TAX CREDITS

By Hollis L. Hyans

The Appellate Division, Third Department, has reversed a decision of the New York State Tax Appeals Tribunal that had denied a refund of personal income tax based on a claimed credit for real property taxes paid by a real estate management company certified as a qualified empire zone enterprise ("QEZE"). *Balbo v. N.Y.S. Tax Appeals Trib.*, No. 524161, 2018 NY Slip Op. 05540 (3d Dep't, July 26, 2018). The court held that, under the circumstances of this case, payment of the real property taxes in question to a mortgage tax escrow account did not preclude the amounts from qualifying as QEZE real property tax credits.

Factual History. Petitioner Angelo Balbo is the sole shareholder of Angelo Balbo Realty Corp. ("Balbo Realty"), and the sole member of Angelo Balbo Management, LLC ("Balbo Management"), which is certified as a QEZE. In 2006, Balbo Management acquired an office complex in Poughkeepsie, New York, and executed a mortgage agreement with a lender. The next year, Balbo Management refinanced the mortgage agreement with the lender, which by this time had brought on Wells Fargo as its servicing agent. Wells Fargo required various modifications to the original mortgage agreement, resulting in, among other changes, the transfer of ownership of the property from Balbo Management to Balbo Realty, and the monthly property tax payments being sent to Wells Fargo, where they would be held in escrow and thereafter remitted to the appropriate taxing authority on behalf of Balbo Realty, the property owner. In January 2008, Balbo Realty leased the property to Balbo Management pursuant to a lease that specified, among other terms, that Balbo Management was solely responsible for all taxes. Balbo Management made the required tax payments to Wells Fargo, which thereafter paid the real property taxes that were due to the receiver of taxes for the City of Poughkeepsie.

Dispute. In 2011 and 2012, Mr. Balbo and his wife filed joint New York State resident income tax returns, claiming QEZE real property tax credits earned by Balbo Management based upon its payment of real property taxes for the Poughkeepsie property. The Department of Taxation and Finance denied the credits, determining that, although Balbo Management was an eligible QEZE, the Balbos were not eligible for the credit because Balbo Management did not, as a lessee, pay the taxes via a "direct payment" to the taxing authority as required under Tax Law § 15(e)(3), but instead remitted the payments through Wells Fargo, an intermediary. Following a hearing before the Division of Tax Appeals, an Administrative Law Judge sustained the denial, finding that the plain language of

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Tax Law § 15(e) required Balbo Management to tender the property tax payments directly to the taxing authority. The Tax Appeals Tribunal affirmed the ALJ's determination, and an Article 78 proceeding challenging the Tribunal determination was filed.

Court's Decision. The Appellate Division reversed the Tribunal's determination. First, it found that there was no dispute that the Balbos qualified for QEZE tax credits based upon Balbo Management's payment of taxes as a lessee, and no question that Balbo Management made the required tax payments into a mortgage-related tax escrow account, in good faith and in conformity with the mortgage agreement, and that the payments were thereafter timely remitted to the taxing authority. The only question was whether the Balbos should be precluded from obtaining the benefit of the QEZE credits solely because of the use of a tax escrow account required by Wells Fargo.

The court found that, "under the particular circumstances presented here," Balbo Management's use of a mortgage tax escrow account did not preclude the Balbos from claiming the QEZE credits.

The court reviewed the statute, Tax Law § 15(e)(3), noting that, in certain circumstances, property taxes paid by a QEZE as a lessee are eligible for the credit, as long as "the lessee has made direct payment of such taxes to the taxing authority and has received a receipt for such payment of taxes from the taxing authority." However, the court found that the statute does not specifically define what type of payment constitutes a "direct payment," and, in the absence of clear statutory direction, it moved on to analyze the statutory language and legislative intent. While recognizing that tax credits are commonly strictly construed against the taxpayer, the court also stated that the interpretation should not be "so narrow and literal as to defeat the statute's intended purpose."

The court found that, "under the particular circumstances presented here," Balbo Management's use of a mortgage tax escrow account did not preclude the Balbos from claiming the QEZE credits. The court concluded that, contrary to the assertion by the Department, once Balbo Management deposited funds into the escrow account, neither Balbo Management nor Balbo Realty had any further control over those funds, and Wells Fargo, as servicing agent, had no discretion over utilization of the funds, which were specifically earmarked for the payment of the real property taxes. The court also noted that, in analogous circumstances, the Legislature has approved special legislation allowing similar lessees to obtain QEZE credits when certain payments in lieu of taxes were not made in specific conformity with the applicable Tax Law provisions. Finally, the court found that neither the Department nor any relevant legislative history provided any "cogent policy argument" to support why utilizing a mortgage tax escrow account should have a preclusive effect on the ability to claim a tax credit that is otherwise perfectly valid. It found that the manner in which Balbo Management made the tax payments should be deemed to be the "functional equivalent of a direct payment to the taxing authority" and that the Balbos were entitled to the credit.

ADDITIONAL INSIGHTS

Use of a mortgage tax escrow account is quite common and very often a non-negotiable requirement of a lender. Given the facts as recited by the court, including the facts that the escrow account here was specifically required by the lender and that the tenant had no further control over the funds once contributed, it is hard to understand what policy reasons would support a narrow reading of the statute and denial of the credit, where the QEZE had done everything else required. Since the goal of the QEZE program is to encourage investment in economically disadvantaged areas, strictly limiting the availability of the credit, as the Department tried to do in this case, seems counterproductive.

TAX DEPARTMENT DENIAL OF SALES TAX EXEMPTION ON DEVELOPER'S EXCESS PURCHASES FOR IDA PROJECT UPHELD

By Irwin M. Slomka

A recent decision addresses an issue of first impression involving a hotel developer that, as a designated agent of a New York State industrial development agency, made purchases of materials to construct a hotel at a cost in excess of the amounts it had estimated in its application for tax benefits, presenting the question of whether its exemption from sales tax also applied to sales tax due on those excess purchases. *Matter of Jefferson Hotel Associates LLC*, DTA No. 827618 (N.Y.S. Div. of Tax App., Aug. 16, 2018).

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Background. Jefferson Hotel Associates LLC ("Jefferson Associates") applied for financial assistance through an upstate New York industrial development agency ("IDA") for the construction of a hotel in Monroe County, New York. As is common for IDA projects, the application sought a real property tax abatement, a mortgage recording tax exemption, and a sales and use tax exemption.

The ALJ concluded that the language in the IDA sales tax appointment letters capped the maximum sales tax exemption amount.

The application, made in June 2012, required that Jefferson Associates estimate the costs of construction in order to determine the anticipated sales tax exemption amounts. Based on the estimated construction costs, Jefferson Associates provided the IDA with an estimated sales tax benefit of $223,000. The IDA accepted the application shortly thereafter, approving the appointment of Jefferson Associates as the IDA's agent for purposes of the hotel project and issuing a "Sales Tax Appointment Letter" authorizing Jefferson Associates to make purchases free of sales tax. That letter also stated that "[t]otal costs of the project cannot exceed the project costs" that Jefferson Associates estimated in its IDA application.

The agent appointment letter was thereafter extended twice, once in December 2012 and again in February 2014. Although each revised IDA agency designation letter reflected the same $223,000 estimated sales tax exemption amount, Jefferson Associates filed with the Department of Taxation and Finance annual forms for 2013 and 2014 reflecting a total sales tax exemption of $253,000, approximately $30,000 more than it had previously estimated.

Thereafter, in February 2015, the IDA issued a demand letter to Jefferson Associates referencing statutory amendments to the IDA sales tax exemption rules (discussed below) that became effective on March 28, 2013. The demand letter sought payment of the excess $30,000 in sales tax that Jefferson Associates did not pay and that exceeded the amount authorized. Eventually, in November 2015, the Department itself issued to Jefferson Associates a Notice and Demand seeking payment of the $30,000. Jefferson Associates paid the tax and, following the Department's denial of its refund request, filed a Petition with the Division of Tax Appeals.

Relevant statutory amendments. Directly relevant to the dispute were amendments to the New York General Municipal Law that significantly changed the way IDAs could allow sales tax exemption benefits. As part of those amendments, IDAs were now required to recapture sales tax exemption benefits claimed that were "in excess of the amounts authorized" and remit those amounts to the Department. The Department was authorized to assess tax, penalties, and interest if the excess amounts are not paid over to the IDA. The new law was made applicable to projects established or agents appointed on or after March 28, 2013, and to any "additional funds or benefits" on or after that date relating to existing IDA projects. Gen. Mun. Law § 875.

Dispute. Jefferson Associates maintained that since the hotel project was established, and the agency appointment made, in August 2012 – approximately eight months before the effective date of the amendments to the law – and there were no additional funds or benefits provided after that date, the amended law did not allow the Department to recover the amounts in issue. It also claimed that nothing in the submissions to the IDA indicated that the estimated $223,000 was a "hard limit" on the sales tax exemption benefit.

Decision. The Administrative Law Judge held in favor of the Department, concluding that the excess sales tax amount was properly subject to repayment by the taxpayer. The key issue was whether Jefferson Associates derived any "additional funds or benefits" with respect to the hotel project after March 28, 2013, the effective date of the amendments. The ALJ found that by virtue of the agent appointment extensions granted – one of which took place *after* March 28, 2013 – Jefferson Associates received the "benefit" of an extension of its status as an agent, which allowed it to continue to make tax-free purchases.

The ALJ also found that the extension of the sales tax appointment letters issued by the IDA, made after March 28, 2013, specifically identified the lower sales tax exemption amount. The ALJ concluded that the language in the IDA sales tax appointment letters capped the maximum sales tax exemption amount. Otherwise, the ALJ noted, the available benefit amount would be "unlimited." While Jefferson Associates could have sought an amendment to the hotel project when it became evident that the originally estimated costs were too low, the ALJ pointed out that such an amendment would clearly have been subject to the recovery provisions of the amended law. Thus, the ALJ sustained the Department's denial of Jefferson Associates' refund claim.

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ADDITIONAL INSIGHTS

The decision addresses two issues, the first of which is whether estimated sales tax exemption amounts constitute a cap on the sales tax exemption benefits. The ALJ concluded that they did, a conclusion buttressed by the fact that, if there were not a cap, then there would be no limitation on the exemption amount allowed. That conclusion became relevant to the second issue – whether, despite the fact that the IDA application predated the effective date of the statutory amendments, the extensions of the agent designations constituted amendments involving "additional funds or benefits" made on or after March 28, 2013. It is debatable, however, whether the routine extensions given by the IDA conferred "additonal . . . benefits" to the taxpayer after the effective date of the new legistlation.

NEW GUIDANCE RELEASED ON NEW YORK TREATMENT OF SECTION 965 REPATRIATION AMOUNTS

By Irwin M. Slomka

The proper New York State tax reporting of federal deemed repatriation income under the Federal Tax Cuts and Jobs Act of 2017 for corporations and flow-through entities is the subject of two newly released pronouncements by the New York State Department of Taxation and Finance. *Important Notice*, "Tax Treatment of IRC § 965 Repatriation Amounts for Tax Year 2017 for New York C Corporations, Insurance Corporations, and Exempt Organizations," N-18-7 (N.Y.S. Dep't of Taxation & Fin., August 2018); *Important Notice*, "Tax Treatment of IRC § 965 Repatriation Amounts for Tax Year 2017 for Flow-through Entities," N-18-8 (N.Y.S. Dep't of Taxation & Fin., Aug. 2018).

Background. The Federal Tax Cuts and Jobs Act of 2017 provides for a one-time repatriation of foreign income from controlled foreign corporations ("CFCs") in the transition year. This is effectuated in steps, first, by increasing taxable income under IRC § 965(a) to take into account accumulated deferred income from CFCs, generally as of December 31, 2017, for calendar year taxpayers ("§ 965(a) inclusion amount") and then providing a partial deduction ("participation exemption") under IRC § 965(c), which results in a lower effective federal tax rate (either 15.5% or 8%). For federal purposes, the taxpayer may elect to pay the resulting transition tax over eight years.

The Notices contain detailed instructions for reporting the repatriation amounts, some of the highlights of which are summarized below:

New York C Corporations (*Notice* N-18-8).

- C corporations must use their federal IRC § 965 Transition Tax Statement amounts, with all IRC § 965 amounts included, in preparing their 2017 New York State returns. (In those infrequent cases where a corporation is part of a federal consolidated group but files separately for New York State purposes, the corporation must prepare a pro forma computation showing IRC § 965 amounts computed on a separate basis.)
- Corporate partners are required to include their distributive shares from partnerships when computing their IRC § 965 amounts for New York State purposes.
- Since the § 965(a) inclusion amount qualifies as "exempt CFC income" under Article 9-A – which the New York State Legislature specifically confirmed this past spring – corporations must either add back interest deductions directly or indirectly attributable to that exempt income or make a revocable "safe harbor" election reducing exempt income by 40%.
- Since IRC § 965(a) income is exempt from New York tax, corporations must add back for New York purposes any IRC § 965(c) deductions claimed for federal purposes.
- The Notice reminds corporations that exempt CFC income is not included in the numerator or denominator of the business apportionment factor.
- Insurance corporations must use a new subtraction modification for the IRC § 965(a) amounts received from foreign corporations that are not included in a combined Insurance Corporation Combined Franchise Tax Return. The Notice states that this amount does not qualify as excludable income from subsidiary capital or for the 50% exclusion for non-subsidiary dividends.

Flow-Through Entities (*Notice* N-18-8).

- Flow-through entities (including New York S corporations and partnerships and LLCs treated as partnerships for federal purposes) must include their distributive and pro rata shares of any IRC § 965 amounts received from other flow-through entities.

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- New York State S corporations must treat the net IRC § 965 amount as dividends from stock under Tax Law § 210-A(5)(a)(2)(G) in computing their business apportionment factor. If the "8% fixed percentage method" sourcing election has been made, and the stock generating the income is a "qualified financial instrument," then 8% of the net IRC § 965 amount must be sourced to New York State in the apportionment factor. If the election has not been made, then the §965 amount is not included in the S corporation's apportionment factor at all.

- For partnerships and LLCs treated as partnerships, the Notice instructs that IRC § 965 amounts are not reported on Form IT-204 (the New York Partnership Return), but rather on each partner's Form IT-204-IP (New York Partner's Schedule K-1) using amounts from the partner's Federal Schedule K-1. The Notice points out that IRC § 965 amounts are only considered to be derived from New York State sources to the extent the stock of the corporation generating the IRC § 965 amounts was used in a trade or business in New York State.

Overall, the Notices reflect a reasonable interpretation of the current New York Tax Law as it pertains to repatriation amounts, and provide helpful guidance to taxpayers in preparing their 2017 New York State returns. Both Notices caution that corporations and flow-through entities that have already filed their 2017 New York State returns must file amended returns to conform to the instructions contained in the Notices.

NEW YORK COURT ANNULS NYC'S REVOCATION OF DIALYSIS CENTER'S TAX EXEMPT STATUS

By Hollis L. Hyans

Adhering to the result reached by the same judge for an earlier tax period, the Supreme Court, New York County, held that the New York City Department of Finance failed to meet its burden of demonstrating that a previously granted tax exemption is no longer valid. *Brookdale Physicians' Dialysis Assocs., Inc. v. Dep't of Fin.*, Index No. 156074/2017, 2018 NY Slip Op. 31841(U) (Sup. Ct. N.Y. Cty., Aug. 2, 2018).

Facts. Petitioner Samuel and Bertha Schulman Institute for Nursing and Rehabilitation Fund, Inc. ("Schulman Institute") is the owner of a building on Church Avenue in Brooklyn, New York, and is a not-for-profit corporation that provides funds for charitable healthcare purposes through The Schulman and Schachne Institute for Nursing and Rehabilitation ("Nursing Institute") and The Brookdale Hospital. Both the Nursing Institute and Brookdale Hospital are located one block from the Church Avenue building and are affiliated with each other under the Brookdale Health System. Petitioner Brookdale Physicians' Dialysis Associates, Inc. ("Brookdale Dialysis") is a for-profit corporation that occupies the first floor and basement of the Church Avenue building, for which it pays rent. Brookdale Dialysis services 80% of the patients from Brookdale Hospital; its physicians work at Brookdale Hospital and the Nursing Institute; and its nurses, technicians, and staff are Brookdale Hospital staff. Brookdale Hospital relies on Brookdale Dialysis' machines, which are used in providing over 8,000 in-patient treatments per year. Another 22,000 treatments are provided for out-patients in the Church Avenue building.

The Department of Finance had granted exempt status for the Church Avenue building. In 2013, it revoked petitioners' exempt status for the 2014/2015 tax year forward. It had previously revoked the exemption for an earlier year, and in February 2014, the same judge as in the present case heard an appeal of that revocation, and found that the Department's sole reliance on the fact that Brookdale Dialysis is a for-profit corporation, without considering the enmeshment of the operations with Brookdale Hospital, failed to meet the Department's burden to show that the property was no longer eligible for the exemption. The Department did not appeal the decision for the earlier year.

The Parties' Positions. The Department argued that because the Schulman Institute is making a profit on its lease to Brookdale Dialysis, the use of an exempt property for profit-making purposes takes the property out of exempt status, regardless of how enmeshed the operations are with a not-for-profit organization. According to the Department, the Schulman Institute should have no costs, since Brookdale Dialysis is responsible for paying all utility, repair, and maintenance costs of the property and the cost and maintenance of its machinery. Under these circumstances, the Department argued, petitioners are making a profit from the exempt property–the not-for-profit landlord profits through the rental income, and the for-profit tenant profits by operating from an exempt property. Therefore, the Department argues that because the Schulman Institute is not a "free public hospital" or a provider of health care, petitioners are not entitled to an exemption under RPTL 420-a(5).

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The petitioners argued that the Department has again failed to meet its burden to show that the property is no longer eligible for the exemption.

Decision. The court noted that the facts in the current litigation were unchanged from those in the earlier proceeding, although the Department had introduced "new evidence" that the Schulman Institute profits from the rent it receives. The judge found that the burden is on the Department to establish that the property is not exempt because it was trying to revoke a previously granted exemption. The judge went on to note that the Department, while acknowledging this burden, nonetheless began its analysis by trying to place the burden on petitioners, stating that the "factual allegations . . . in the petition are insufficient as a matter of law to establish that the Subject Property is entitled to an exemption."

The court found that the "new evidence" produced by the Department–that the Schulman Institute profits from the rent it receives from Brookdale Dialysis–was offered in support of the Department's position that an exemption cannot apply if the owner makes a profit, regardless of the use to which the property is put. The court found this argument was "flawed," noting that the inquiry does not stop at the mere fact that the Schulman Institute receives rent from Brookdale Dialysis. Rather, the judge held that the primary use of the property must be examined under RPTL 420-a, citing *Adult Home at Erie Station, Inc. v. Assessor*, 10 N.Y.3d 205, 216 (2008), for the proposition that that "[t]he issue is not whether [the entity] benefits, but whether the property is 'used exclusively' for [the entity's] charitable purposes."

The judge found that the Department had failed to examine the use to which the property was put, and that its determination to revoke petitioners' exempt statute was therefore arbitrary and capricious. She annulled the Department's determination revoking the exemption.

ADDITIONAL INSIGHTS

This case, its predecessor, and others decided recently by the courts (for example, *Greater Jamaica Development Corp. v. New York City Tax Commission*, 25 N.Y.3d 614 (2015) (discussed in the August 2015 issue of *New York Tax Insights*)), do make it clear that, when a property tax exemption has been granted, and then the taxing authority seeks to revoke the exemption, it is the taxing authority that bears at least the initial burden of showing what has changed. The relevant inquiry does not stop at whether the owner is earning a profit, but must consider whether the "principal" or "primary" use is for charitable purposes. Here, because the Department failed to examine the primary use, it did not meet its burden to revoke the exemption. It is worth noting that, in *Greater Jamaica Development*, the Court of Appeals, over a dissent and reversing the Appellate Division, Second Department, found in that case that the Department had successfully demonstrated that facilities were not used for a charitable purpose, or a purpose incidental to a charitable purpose, but instead were used for economic development, and the facilities were not entitled to exemption. The critical question remains the use of the property.

INSIGHTS IN BRIEF

ALJ DENIES REQUEST FOR REFUND OF PERSONAL INCOME TAX

An ALJ has granted a motion for summary determination filed by the Department of Taxation and Finance on the grounds that the tax asserted was due and the notice had been timely issued. *Matter of Erika D. Rodriguez*, DTA No. 827935 (N.Y.S. Div. of Tax App., Aug. 9, 2018). The petitioner filed a New York State Income Tax Return for 2012 on or about April 15, 2013. On March 21, 2016, the Department issued a notice of deficiency asserting tax due of $383 plus interest, based on a comparison of petitioner's New York State return with information provided by the Internal Revenue Service, which the petitioner conceded was correct. The ALJ rejected the petitioner's argument that she should not be held liable because nearly three years had elapsed between the filing and the notice of determination, pointing out that, while the notice was issued "on the eve of the statute of limitations for assessment expiring," it was issued within the three year window required by Tax Law § 683, and, in the absence of any evidence of unreasonable errors or delay, was timely.

REFUND IS DENIED OF SALES TAX PAID AT OUTSET OF CAR LEASE, EVEN WHEN CAR IS MOVED OUTSIDE NY

An ALJ has upheld the Department's denial of a refund of sales tax to an individual who leased a car in New York in February 2014 for a term of 39 months, paid the full amount of New York sales tax due at the time of the first lease payment, but then relocated to Arizona in the summer of 2015, re-registered the car, and was required to pay an additional monthly charge for the Arizona transaction privilege tax for the remaining lease term. *Matter of Irving Pollack*, DTA No. 827607 (N.Y.S. Div. of Tax App., Aug. 9, 2018). The ALJ noted that, since 1990, Tax Law § 1111(i) has explicitly required that all sales tax on certain leases of motor vehicles for one year or more is due as of the first payment. The petitioner argued that there is no express provision prohibiting a refund based on relocation of the vehicle, but the ALJ rejected this argument, finding that the Tax Appeals Tribunal has on a number of occasions denied refunds under similar circumstances.

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TAX DEPARTMENT RULES THAT VENDOR COULD NOT HAVE ACCEPTED A SALES TAX EXEMPTION CERTIFICATE IN GOOD FAITH

The New York State Department of Taxation and Finance has issued an Advisory Opinion involving a vendor that rented a truck to a customer and received a completed exempt purchase certificate from the customer indicating that tangible personal property was being purchased for use in a project for an exempt organization and that such property would become “an integral component part” of a building or structure. The Department concluded that the vendor could not have accepted the certificate in good faith, since it should have been clear that the truck would not become a component part of an exempt organization’s building or structure. *Advisory Opinion*, TSB-A-18(2)S (N.Y.S. Dep’t of Taxation & Fin., June 5, 2018, released Aug. 1, 2018). Accordingly, the Department ruled that the vendor should have collected sales tax from the customer on the purchase.

REJECTING HARDSHIP CLAIM, TRIBUNAL SUSTAINS DRIVER’S LICENSE SUSPENSION REFERRAL

A driver’s license suspension referral against an individual with more than $2.6 million in tax assessments subject to collection was sustained by the Tax Appeals Tribunal. *Matter of Anthony Nastasi*, DTA No. 828087 (N.Y.S. Tax App. Trib., July 16, 2018). The individual claimed that the driver’s license suspension would cause him a significant hardship that would effectively prohibit him from paying his outstanding tax liabilities. Noting that the Tax Law prescribes only limited bases for challenging a driver’s license suspension, the Tribunal upheld the suspension, pointing out that the Tax Law does not provide for any relief based on hardship.

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